INTERNET TAX NONDISCRIMINATION ACT

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

ON

H.R. 49

APRIL 1, 2003

Serial No. 13

Printed for the use of the Committee on the Judiciary

Available via the World Wide Web: http://www.house.gov/judiciary

U.S. GOVERNMENT PRINTING OFFICE
86–182 PDF WASHINGTON : 2003

For sale by the Superintendent of Documents, U.S. Government Printing Office
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INTERNET TAX NONDISCRIMINATION ACT

TUESDAY, APRIL 1, 2003

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL
AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:01 a.m., in Room 2141, Rayburn House Office Building, Hon. Chris Cannon [Chairman of the Subcommittee] presiding.

Mr. CANNON. Good morning, ladies and gentlemen. This hearing of the Subcommittee on Commercial and Administrative Law will now come to order.

We consider today H.R. 49, the Internet Tax Nondiscrimination Act. This bill, sponsored by Representative Chris Cox and cosponsored by me and 88 other of our colleagues, would eliminate permanently the imposition of multiple and discriminatory taxation by States on electronic commerce and would ban States' taxes on access to the Internet.

H.R. 49 follows from earlier legislation, the Internet Tax Freedom Act of 1998, or the ITFA, which imposed a 3-year moratorium on multiple and discriminatory State taxation and on new State taxes on Internet access. During the 107th Congress, we considered several approaches as the end of the moratorium neared. The legislation ultimately enacted extended the moratorium until November 1 of this year.

As we all know, electronic commerce has witnessed the ebb of economic tides. According to the Department of Commerce, the second half of 2000 marked an economic turning point. Falling profits have weakened business investment and also threaten the commercial potential of the Internet. The challenges facing the IT industry underscore the urgency of extending the moratorium. But these economic conditions aside, it makes sense to banish multiple and discriminatory taxes on e-commerce or any other type of commerce. By definition, multiple and discriminatory taxes cannot be justified, a fact acknowledged by my colleagues on both sides of the aisle during prior consideration of the moratorium.

The bill also bans State taxation on access to the Internet. While a little over one-half of the U.S. population currently uses the Internet, prohibiting Internet access taxes would facilitate growing participation in electronic commerce for all Americans.

During the debate in the 107th Congress, the moratorium issue became linked with the issue of whether out-of-State sellers, such as Internet retailers, should be forced to collect taxes and use taxes

on their remote sales—that is, collect sales and use taxes on their remote sales. Some Members argued that the moratorium and sales tax issue must be considered together in order to truly address Internet taxation.

What must be made abundantly clear is that H.R. 49 does not prevent taxes on online sales. This bill simply prevents taxation on Internet access and taxation that singles out Internet users for unfair treatment.

It is my firm belief that these two issues are separate and should be so considered. A permanent extension of the moratorium should stand on its own and should not be unnecessarily joined with other subjects. Linkage of the moratorium with the online sales tax can only confuse the straightforward concepts of a moratorium. The moratorium faces a real deadline, November 1 of this year, and we must consider it now or face the potential deluge of duplicative and discriminatory taxes on the Internet.

Moreover, consideration of the sales tax issue at this time is premature. Although States have made impressive efforts to modify their tax laws to comply with the streamlined sales tax agreement, to date, only a few have done so. Supporters of this effort are unlikely to present Federal legislation on the sales tax collection issue until more States have brought their laws into compliance with the agreement. In the very near future, as the effort progresses, the Subcommittee plans to vet fully the complex issues surrounding the sales tax collection issue in a separate hearing.

Department of Commerce Secretary Donald Evans has noted, "Achievement of the IT revolution's full potential will demand skillful public action to guarantee that all Americans can participate freely according to their own goals and talents in the promise of the digital economy. On all sides, much remains to be done."

It is time for us to do what needs to be done.

I now yield to Mr. Delahunt, who is sitting in for Mr. Watt, the Ranking Member. Do you have an opening statement, Bill?

Mr. WATT. No, I don't have an opening statement, but I do have a statement by the Ranking Member of the full Committee, Mr. Conyers, that I would ask unanimous consent to be submitted.

Mr. CANNON. Without objection, so ordered.

[The prepared statement of Mr. Conyers follows:]

PREPARED STATEMENT OF THE HONORABLE JOHN CONYERS, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

When considering whether or not we should permanently extend the Internet tax moratorium as suggested in H.R. 49, there are two equally important issues that must be considered. First, we must consider whether we should extend the moratoriums on Internet access and multiple and discriminatory taxes that we passed in 1998. On this issue, nearly all the interested parties appear to agree that we should extend the moratorium. It is difficult to justify multiple and discriminatory taxes under any circumstances, on the Internet or otherwise.

The second issue concerns the issue of nexus for sales tax purposes. This issue is far more complex and ultimately, far more important. Pursuant to the Supreme Court's decision in Quill, a state cannot tax a remote seller unless it has a "substantial physical presence" in a state. Thus, the traditional brick and mortars sellers are required to collect sales tax while the electronic retailers have no such requirement, creating an unlevel playing field between the two.

Sales taxes constitute the most important State and local revenue source, with the census bureau estimating that nearly one half of State and local revenues come from sales taxes. Projections of increasing online sales indicate huge revenue loses for states and local government. For example, my own state of Michigan was esti-

mated to lose $502.9 million in foregone sales taxes in 2001 and that number will triple by 2006 under the present system.

This inevitably translates into the loss of important funding for quality education, effective public safety, and other basic services. In Michigan, the lost revenue from foregone sales taxes will cost my state over 100,000 teachers or police officers this year. Think of how much we could do to reduce class sizes, build new schools, improve our quality of education and protect our streets, communities, and citizens with these funds.

The states, however, have made substantial progress on their streamlining initiative. Specifically, representatives of 34 states, including Michigan, settled on a framework that individual state legislatures can use to streamline their tax code. The framework would make it easier for corporations to collect and pay taxes across state lines and in states where they operate only via the Internet. Congress, which has authority over interstate commerce, must approve the compact prior to its enactment.

Thus, our burden is far greater than simply passing another extension of the moratorium. I am hopeful that Congress will also consider and pass provisions to provide states that simplify their sales tax systems with the authority to collect sales taxes equitably from all retailers. A simplified streamlined tax compact would increase our nation's economic efficiency, facilitate the growth of electronic commerce, and help us maintain our communities.

Mr. CANNON. The Chair would just note that we have a 5-minute rule on the Committee. It makes the system work a lot better if we adhere to that rule. As time runs out, either for members of the panel or for Members asking questions, I will tap the gavel lightly just to remind, and if we could finish up the thought and wrap, we'd appreciate that and that'll allow us to get to the point where we can—everyone can ask questions.

The Chair welcomes the presence on the dais of the gentleman from California, Mr. Cox. Although not a Member of this Subcommittee, he is the sponsor of the legislation which is the subject of today's hearing. He is well known by the Subcommittee for his valuable testimony as provided us in prior hearings on this issue. Mr. Cox, we welcome you and we are grateful for your continuing efforts.

The Chair exercises his discretion in this instance and would recognize Mr. Cox for a few minutes for any remarks he wishes to make. Mr. Cox?

Mr. COX. Thank you, Mr. Chairman. Thank you for your many years of leadership in preventing unfair and destructive taxes on the Internet and for your leadership today in holding this hearing on the Internet Tax Nondiscrimination Act.

Thanks also for providing us with this distinguished panel of witnesses that I'm looking forward to hearing from this morning.

I believe that there is strong opposition in this room, strong, broad, and bipartisan opposition to new regressive taxes on the Internet. Existing law prevents taxes which will make Internet access less affordable for lower-income consumers, less available for rural consumers, less accessible to those who are still seeking to join the information economy. We are here to see to it that this law does not expire. Instead of allowing the taxation of Internet access, Congress should seek to remove the barriers that prevent people from enjoying this amazing technology.

The Internet is an amazing and liberating technology for the individual, for students, for entrepreneurs, for consumers, for journalists, for businesses, for senior citizens, and for people in every walk of life. We don't need to subsidize it. We simply need to not destroy it through taxation.

A January 2003 UCLA study reports that consumers now rank the Internet as their most important source for information. Widespread adoption of broadband high-speed Internet connections would add an additional half-trillion dollars to the U.S. gross domestic product in each of the next 10 years, according to a recent study by market researcher Dataquest. New taxes that would make the high-speed Internet even less affordable will do nothing but discourage the adoption of broadband connections.

In addition to preventing regressive taxes on Internet access, H.R. 49 has other benefits to protect the Internet from unfair treatment at the hands of tax collectors. My legislation, as the Chairman points out, does not prohibit online sales taxes. It prohibits multiple and discriminatory taxes. In other words, multiple governments in different locations can't tax simultaneously the same transaction. Online sales can't be taxed at each stop along the electronic path between buyer and seller.

And tax collectors cannot discriminate against web consumers by taxing goods and services online that are not taxed offline. Just as it sounds, the Internet Tax Nondiscrimination Act would ensure that Internet consumers are not burdened with taxes that don't exist in the bricks-and-mortar world.

So the question is simply put before us, should Americans be forced to pay new taxes on their Internet access? This question has been asked and answered many times by many distinguished people, including some of the people we will hear from next on this panel.

Should the diverse and growing population of Internet users pay double or triple the tax they pay at the mall just because they choose to shop online? Should these consumers pay taxes online that have never existed in the offline economy? The answer to all of these questions should clearly be no.

State and local governments continue to wrestle with the important questions of how to balance budgets and how to treat online transactions. The sales tax debate is one that must continue and will continue, and it must also be separated from the debate on this bill, which is not about sales taxes.

Some of you here probably remember the National Lampoon cover that featured that really cute little puppy, and this puppy had a revolver to its head and the cover of the National Lampoon said, "Buy this magazine or we'll shoot the dog."

That's what's going on with the debate over Internet sales taxes and this legislation to continue the ban on multiple and discriminatory taxes. There is no constituency for multiple taxes or discriminatory taxes against the Internet. Nobody is willing to say, we are for this. There is no time in the future when this will be a good idea, and it's time permanently now to ban this. We ought not to be here, Mr. Chairman, 2 years from now or 3 years from now, going around the same track over again.

This is very much like "Groundhog Day," and as much as I enjoy having my legislation passed by Congress not just once but multiple times, because it's quite an honor, I think we've done this and now it's time to finish the job and then we can move on and talk about other more difficult issues in the days ahead.

Thank you very much, Mr. Chairman. I yield back.

Mr. CANNON. Thank you, Mr. Cox. I agree with you. Passing it twice—three times is the charm, right? Let's do it this time.

The Chair would acknowledge the presence of Ms. Baldwin from Wisconsin and Mr. Delahunt from Massachusetts. Mr. Coble was here briefly, but he had another hearing that he had to attend. Mr. Flake was here and I think will be back. Mr. Carter from Texas and Mr. Chabot from Ohio, who I think will return.

Thank you, Mr. Cox. We appreciate those comments.

And now, we'd like to turn to our rather—our extremely impressive panel. It is my honor and privilege to welcome these individuals, these gentlemen here today, who are among the most noted experts in the area of Internet taxation.

First of all, we'll hear from my friend, Governor—the Honorable James S. Gilmore, III, our first witness and the former Governor of the Commonwealth of Virginia from 1998 to 2002. As Governor, Mr. Gilmore fostered a strong leadership—or relationship between the Government and the technology community. He created the nation's first Secretariat of Technology, established a Statewide Technology Commission, and signed into law the nation's first comprehensive State Internet policy.

As a result of his leadership on technology issues, Mr. Gilmore was chosen as Chairman of the Federal Advisory Commission on Electronic Commerce, the panel established by enactment of the Internet Tax Freedom Act that issued its report to Congress in April of 2000.

In addition, Mr. Gilmore has been Chairman of the Congressional Advisory Panel to assess domestic response capabilities for terrorism involving weapons of mass destruction, also known as the Gilmore Commission. This commission was influential in developing the office of Homeland Security.

A graduate of the University of Virginia and its law school, Mr. Gilmore continues to demonstrate his dedication to technology issues as a partner in the law firm of Kelley, Drye and Warren here in Washington, D.C.

Mr. Gilmore, we are grateful for your commitment to the important issues before us today and your valuable testimony, and may I just add, we appreciate the fact that a governor has taken the lead in opposition to other governors around the country on an issue that is so fundamentally important to America.

Let me just ask, obviously I have been passed a note. Mr. Kemp, do you need to go first?

Mr. KEMP. I'm such an expert in e-commerce, I can't get the——

Mr. CANNON. Governor, if you would pardon us, Mr. Kemp, if you don't mind, I'd like to introduce you.

Mr. GILMORE. Congressman, I'm certainly prepared to defer to the Secretary, but I hope I'll get that introduction over again. That was very nice. [Laughter.]

Mr. CANNON. We probably could ad lib and do a lot more, given your background on this issue. I don't think it's a surprise to anyone that my Governor in Utah has sort of been on the lead on the other side of this, and while I love my State, I love the Internet in many ways more. So we'll come back and do some more introduction, Governor.

Our next witness, then, will be Mr. Jack Kemp, who is one of the nation's leading promoters of the importance and potential of the digital economy. Mr. Kemp serves on the Board of Directors of Empower America, a public policy and advocacy organization he cofounded in 1993. Empower America is dedicated to promoting democratic capitalism, economic growth, and policies that empower individuals.

A graduate of Occidental College in Los Angeles, Mr. Kemp served for 4 years as Secretary of Housing and Urban Development before his appointment to the cabinet, and after a successful professional football career. Mr. Kemp served for nine terms here in the House of Representatives, from 1971 to 1989. In 1995, Mr. Kemp served as Chairman of the National Commission on Economic Growth and Tax Reform. In 1996, he was nominated as the Republican candidate for Vice President for the United States.

In addition to his work with Empower America, Mr. Kemp holds many prestigious appointments, including serving as Deputy Chairman of the International Democratic Union, a worldwide organization dedicated to advancing democracy, freedom, and free market conditions.

Mr. Kemp, it is great to have you back in these hallowed halls. I might just as a personal note say that I have been a great admirer of Mr. Kemp's and he has been very gracious with his time on these issues with me since I have come to Congress. I appreciate your coming here today and sharing your counsel and wisdom with us, Mr. Kemp. We shall turn the time over to you.

STATEMENT OF HONORABLE JACK KEMP, CO-DIRECTOR, EMPOWER AMERICA

Mr. KEMP. Thank you. Well, Mr. Chairman, thank you for that very gracious introduction, and Members of the Committee, it is a pleasure to be before you. Listening to my old friend, Chris Cox, talking about e-commerce and taxation reminds me of our old friend Ronald Reagan's comment about Government. He said, one of the problems is, any time they see something moving, they want to tax it. If it keeps moving, they want to regulate it. If it ever stops moving, it'll be subsidized by Government. [Laughter.]

Mr. KEMP. Chris, thank you for your comments. Mr. Chairman, thank you for your gracious introduction. Let me say it's a pleasure to be here with Governor Gilmore. There is no governor in the country for whom I have higher regard and respect than Jim Gilmore. He also serves with me on the Board of Empower America, and after chairing the Advisory Commission on Electronic Commerce, I have come to believe that this is one of the most important issues facing the United States in the 21st century, the whole idea of a new economy. It doesn't replace bricks and mortar, but it expands commerce here and around the world. It is a duty-free e-commerce, it is tariff free, and hopefully, we can keep it as tax-free as is potential.

It will add to the revenue base of the country. All revenues don't have to come in one direct way. There are many different ways to expand the revenue base of this country, and as that pie continues to grow or we get it growing again, we are going to get more rev-

enue, as I have preached and Jim Gilmore has preached and many of you have preached for many, many years.

So I am pleased to be here. I will keep my remarks brief. That will, of course, be an historical occasion here in the Congress, these hallowed halls. [Laughter.]

Mr. KEMP. States have been trying for years to tax people at businesses located out of State. The issue of taxing remote sales started when States tried to tax catalog sales, arguing that such favorable tax treatment put brick-and-mortar companies at a disadvantage. This is not a new debate. It has been going on ad infinitum, if not ad nauseam.

The Supreme Court in 1992, as you all know, *Quill* v. *North Dakota*, barred the State of North Dakota from requiring an out-of-State mail order company to collect taxes on sales made to customers inside the State unless the business had that substantial presence or nexus alluded to by the Court.

With the advent of the Internet in the mid-1990's and the growth of e-commerce, some say in the next 5 years, close to $1.5, $1.7 trillion of e-commerce. Ninety-five percent of it is B-to-B. It is not B-to-C, it is B-to-B, wholesale where there is no sales tax.

In 1998, the Internet tax debate was temporarily stayed for 3 years with the passage of the Internet Tax Freedom Act, alluded to by you, Mr. Chairman, and by Mr. Cox. It barred post-1998 access taxes on the Internet as well as multiple and discriminatory taxes, again alluded to by Mr. Cox.

In 2001, when the ITFA was set to expire, the fight to permanently or temporarily extend the moratorium was held hostage by some Members of the Senate unless Congress allowed for some type of a national sales tax cartel to exist. In November, almost 2 months after the original moratorium had expired, the Senate finally passed that clean 2-year extension and we think the Congress should pass a clean extension, or a clean moratorium, I should say, this year.

During the first two rounds of the Internet tax debate, many argued that the central issue was fairness. Supporters of Internet tax harmonization obfuscated, in my opinion, the issues, insisting that somehow the moratorium barred taxation of Internet sales, leaving brick-and-mortar industries at a disadvantage.

The Internet tax moratorium and the extension of the permanent moratorium only bars access fees, as Mr. Cox alluded to, and multiple and discriminatory taxation. It's the U.S. Constitution and the Supreme Court precedent, not the moratorium, that imposes the restriction on the ability of a State and local government to tax remote sales.

That's an important point to make, it seems to me, along with the point that now as States are running deficits—and clearly the deficit is a result of the slow-down of the U.S. economy and an increase in spending that took place in the 1990's when the economy was growing—with States running deficits, it is interesting that now the talk of fairness is being replaced by the so-called plugging of a budget shortfall. I think that is fallacious, Mr. Chairman. States have increased spending over 50 percent in just three or 4 years. Clearly, they took advantage of a growing economy. I don't

see how we're going to close a gap or plug the States' deficit by 30 to 40 percent by putting on a tax.

Congress should pass H.R. 49. I appreciate your leadership and that of Mr. Cox and other Members who have supported this. We should permanently extend the current Internet tax moratorium on access taxes and multiple and discriminatory taxation of e-commerce. Congress should definitively end any hope that some have of a Congressional authorization of a national sales tax cartel.

I see the red light on. I am going to follow my instructions. I will leave my colleague to answer the questions as I catch an 11 o'clock shuttle, if that is possible, to New York.

Mr. CANNON. We wish you godspeed. [Laughter.]

Mr. KEMP. Thank you.

Mr. CANNON. And a safe arrival.

Mr. KEMP. I'm leaving Reagan National, but it'll also make you all realize that you have a witness here in Governor Gilmore who is probably the most able practitioner of these views that we have in the country. Thank you, Mr. Chairman, and godspeed to you.

Mr. CANNON. Thank you, Mr. Kemp. We appreciate your time.

[The prepared statement of Mr. Kemp follows:]

PREPARED STATEMENT OF JACK KEMP

Mr. Chairman and Members of the Committee, thank you for allowing me to express the views of Empower America on H.R. 49, the Internet Tax Nondiscrimination Act, which would permanently extend the existing moratorium on many forms of internet taxation (the Internet Tax Freedom Act of 1998—ITFA—as extended in November 2001 by the Internet Tax Nondiscrimination Act of 2001 until the fall of this year). We at Empower America enthusiastically support H.R. 49. In my few minutes before you this morning, I would like to explain why we support the bill and point out some potential pitfalls the committee should be wary of as you seek a more permanent resolution of this complex but extremely important issue.

First, I would like to note that Empower America has actively participated in the Internet tax debate since it began with the Advisory Commission on Electronic Commerce (ACEC), chaired by my good friend Gov. James Gilmore who I am glad to see has been called upon to testify as well. My views expressed today are based on the work Empower America has done on this subject in the past and on work we are presently doing in preparation for a white paper on some of the economic and legal issues surrounding Internet taxation (a copy of that study will subsequently be submitted for the Committee's consideration).

Mr. Chairman, I believe a good starting point for understanding the Internet tax debate is laid out in the conclusions of the congressionally-mandated ACEC, which was conducted under the outstanding leadership of Virginia Gov. James Gilmore. The Commission did an excellent job of framing the issues involved with Internet taxation from the perspective of protecting the taxpayer, advancing economic growth, and balancing the interests of the states and the national government with due regard for our constitutional structure and provides a blueprint for Congress to consider in asserting its power to define the scope of states authority to tax cross-border transactions. Another excellent source discussing the Constitutional limitations on Internet taxation is a paper published by the Institute for Policy Innovation (IPI) titled, "New Economy, Old Constitution," by George Pieler and Empower America Chief Economist Dr. Lawrence Hunter.

However, the authority and foundation on which we rest our case is not on the Commission's recommendations or policy studies alone; we rest our case on the firm authority and foundation of the Constitution, Supreme Court precedent and sound economic policy. It is this authority that should guide the members of this Committee and members of Congress as you seek to reach a consensus to ultimately resolve this issue.

In the last six years the debate over Internet taxation has changed with the economic climate. During the mid-to-late 1990s as e-commerce, the economy and states tax revenues all took-off (no coincidence) the focus of the debate by those whom were against the moratorium and in favor of sales tax simplification was on the issue of "fairness." Their case rested on the simple proposition that it is simply

wrong to give Internet-based companies preferential tax treatment over brick-and-mortar industry. And, I would agree if that were the case, but it is not.

The ITFA does not prevent states from taxing e-commerce if there is a sufficient "nexus" or physical presence between the out-of-state-seller and in-state purchaser in their jurisdiction. The ITFA only bars access fees and multiple and discriminatory forms of taxation on e-commerce. One example of a discriminatory tax might be a surtax on products ordered through the Internet (for example, a state assessing a 10% tax on books

ordered online when it only demands a 5% tax on books bought in a bookstore). Another would be claims by multiple states to collect tax for a single transaction with a buyer in one state and a seller in another, thus doubly taxing. The possibilities for imposing multiple and discriminatory taxes on e-commerce are limited only by the law and the imagination of the taxing authorities.

Let me be clear, the Internet deserves neither special tax burdens nor unique tax privileges. This is the central premise underlying the ITFA and, in practice, it is serving that purpose. The supporters of Internet taxation would like to point to the ITFA as the source of their problems, and they insist the problem is merely a misguided act of Congress that can be remedied with more legislation. But the origins of this dispute are much older than the Internet and the source of their problem is much more permanent than an act of Congress.

The central issue in the Internet tax debate is not "fairness" as the NGA and some others would have us believe; it is taxation without representation. States have been trying for more than three decades to tax people and businesses that are located out-of-state because politicians are acutely aware non-residents can't vote them out of office.

This issue began long before the Internet or the new economy, it began with catalogue sales. The Supreme Court finally settled that dispute in 1992 in *Quill Corp.* v. *North Dakota*. That decision barred states from requiring out-of-state mail order companies from collecting taxes on sales made to customers inside the state unless the business had a "substantial presence" within the state. In addition to finding no sufficient taxing "nexus" the Court also found the North Dakota tax scheme too complex for remote sellers and thus created an "undue burden" on inter-state commerce, rendering the tax scheme unconstitutional and settling the issue for the time being. So the Constitution, not the ITFA, nor some quaint notion of "fairness", is the barrier to the states scheme to tax e-commerce.

By 2001 the technology sector of the economy was devastated by deflationary monetary policy and an ever increasing regulatory and tax burden from which it has yet to recover. Concurrently, federal, state and local tax revenues declined with the sagging economy. A key lesson to be learned from the rise and fall of the technology sector during the late 1990s through 2003 is that economic growth is the key to solving federal, state, and local fiscal problems, not a systematic search for new and creative ways to increase the tax burden on hardworking Americans.

Undaunted by the facts, supporters of the new and multiple taxation on e-commerce have shifted gears; no longer is the issue one of fairness alone, now they argue taxation of e-commerce is necessary to plug state budget deficits. But, as we have seen, economic growth not new forms of taxation is the key to solving budget shortfalls and we need to keep in mind that no government neither here nor abroad has ever taxed its way to prosperity.

Another issue first raised in the *Quill* case, which was debated by the ACEC, and is being pushed aggressively by the National Governors Association (NGA) is the agenda for 'harmonization' and 'simplification' of state sales tax laws which would create a de facto national sales tax for which neither the federal government or the states would be accountable to the taxpayer. Under the proposed plan, supporters of the 'streamlined sales tax initiative', probably more properly labeled the 'national sales tax cartel initiative', seek preauthorization from Congress (required under the Compact Clause) for a national sales tax cartel if just 20 states agree to their streamlined sales tax initiative. This national sales tax cartel would be levied collectively by all states and run by a non-elected 'consensus board'; so much for representative democracy.

In 2001, when Congress debated permanently extending the ITFA, the debate was bogged down between those who wanted to make the moratorium permanent, on one hand, and those who wanted to tie any extension of the ITFA to preauthorizing a national sales tax cartel, on the other. Senator Byron Dorgan (D-ND) is already out-of-the box supporting the latter approach. At the winter meeting of the National Governors Association he urged Congress to pass a sales tax "streamlining" bill this year. We feel that if that happened it would probably be the worse case scenario. Besides pushing the Constitutional limits of the Compact Clause, probably overstepping such limits, 'streamlining' or 'harmonizing' sales taxes does not make much

economic sense. Tax competition in our federal system of government keeps governments honest. It allows businesses and individuals to vote with their feet, therefore preventing government overreaching. Tax competition, and competition in general, is a cornerstone of our economic system and federal system of government; it is not a problem that needs to be solved, but rather a solution that should be embraced.

As a result of this political stalemate some are now suggesting that the ITFA and the national tax cartel initiative should be separated, we disagree. In our view the ITFA and the national sales tax cartel initiative are inextricably linked. The purpose of the ITFA was to give Congress time to study the issues so that Congress could pass policy that would foster economic growth in an emerging industry and to give the nascent e-commerce industry a chance to mature. In the interim, the NGA and supporters of a national sales tax cartel have ramped up efforts at the state level so as to give the national sales tax cartel initiative an aura of inevitability. Do not be fooled, Congress need not be a party to this policy boondoggle.

What we have learned from the last eight to ten years is that e-commerce, just like every other sector of the economy, is susceptible to onerous monetary, tax and regulatory policy. We have also re-learned that as the economy goes, so too goes the fiscal picture of governments at all levels. And, if you want an idea of the negative consequences of tax harmonization schemes simply look across the ocean to our European friends. Tax harmonization is nothing more than a euphemism for high taxes and is a recipe for economic stagnation. These issues should be dealt with head-on and resolved decisively in favor of what is Constitutional; while focusing on economic growth and not increasing the tax burden; and safeguarding the proper roles of government.

To this effect our recommendations are simple: we strongly endorse H.R. 49 to permanently extend the ITFA moratorium. We also encourage Congress to resoundingly quash any notion that Congress would even contemplate authorizing a national sales tax cartel. If Congress passed such an authorization it may portend the beginning of what might appropriately be dubbed an Internet tax revolt. And, if some members of Congress should try to hold hostage permanent extension of the ITFA for some "compromise" authorizing a national sales tax cartel, then Congress may be better off allowing the ITFA to expire. The negative impact of a national sales tax cartel is even more daunting than the multiple and discriminatory taxes states could dream up for taxing e-commerce.

States on their own may do as they please, but there is a real danger that the desire for simplicity and uniformity on the part of the business community, coupled with the state and local eagerness for enhanced revenue authority, could create an anti-constitutional tax structure that is neither federal nor state in nature, but a 'third layer' of government unaccountable to the people. At the same time it is appropriate to warn against federal overreaching in this area via excessively prescriptive rules on what states can and cannot do within their sovereign boundaries.

These are matters most worthy of the Committee's consideration in the field of Internet taxation. Again, we applaud the initiative you and your Committee have taken, Mr. Chairman, in seeking to permanently extend the moratorium on unwarranted taxation of the Internet, and we look forward to a stimulating and productive debate over tax policy and fiscal federalism in the months ahead.

Thank you.

Mr. CANNON. I might say, I'm sure that the gentleman from Virginia was joking when he said he'd like another introduction. I'm happy to do that, because I can talk at great length about the contributions of Mr. Gilmore to this debate and the gravitas that he has brought to bear on what I think is the appropriate sight of the debate, which is a permanent moratorium.

Mr. Gilmore, we are honored to have you here and we would look forward to hearing your testimony.

STATEMENT OF HONORABLE JAMES S. GILMORE, III, FORMER GOVERNOR, COMMONWEALTH OF VIRGINIA

Mr. GILMORE. Thank you, Congressman. I wish I were a Member of Congress so I could move that Mr. Kemp be forced to stay here and answer the questions of the Members, particularly Mr. Delahunt and Ms. Baldwin. [Laughter.]

Mr. GILMORE. But I am delighted to be here, particularly with these distinguished additional witnesses who will be making, I think, very persuasive cases to you today. I simply would ask that my written remarks be made a part of the record, if you should please, Congressman.

I have, as you know, usually been testifying on homeland security issues before this Congress. This is a little bit of a different forum today, and compared to the Internet tax debate, homeland security is a peach. So this is a hard one to do, but not this piece.

This piece of H.R. 49 that Congressman Cox has come forward with here today is something you can let go, you can let go ahead, as opposed to having intertwined into the challenging sales tax issue. As a matter of fact, there is risk that if you don't let it go forward, that this can later on in the year become intertwined with the sales tax issue, which is much more complicated, much more difficult, and if it becomes intertwined, it doesn't get enacted, H.R. 49, and then you run the risk that there are going to be additional taxes placed on access, which is a fundamental tax increase right in the middle of a recession.

I just don't think that the Congress wants to take that responsibility, and Congressman Cox has offered you an opportunity to avoid that challenge by going forward with it today. Also, the risk is if you don't go forward with it today and this expires, then there is a risk that there will be a lot of individual access taxes put on.

I want to congratulate Congressman Cox for his leadership in this. He has been doing it for years and continues to. I was, of course, chairman of this Advisory Commission on Electronic Commerce from 1999 to 2000, a most challenging chairmanship to try to perform at. The issue that, of course, we have here today is one that on our Commission had virtually no controversy, very little debate on this issue. The more complicated issues were very controversial, but this was pretty easy, to allow this to go forward.

When you look back at what the Internet Tax Freedom Act did, was it prohibited these kinds of taxes, it grandfathered the ones that were already in existence, unfortunately, but did, and then established the Advisory Commission. Since that time, a lot of these access taxes, in fact, have been dismantled. Texas has eliminated its tax on access. Connecticut phased out its tax on access. Washington State repealed a local tax that was put on by the City of Takoma. So the trend is against access taxes and I think that's right.

But we're talking, really, on this entire array of issues, ladies and gentlemen, a policy choice, which is, of course, the duty of elected officials. It just is. But this is a very challenging policy choice, and now the choice before you on this narrow issue is, do you want to delay this and run the risk that there's going to be myriad State and local taxing burdens, as we have seen, for example, in the telecommunications industry, or do you want to go forward and pass this narrow piece now and avoid that kind of difficulty?

This is a permanent moratorium that's being offered and I think that it's the right policy, and there are policy reasons for this.

Number one, it promotes the freedom and ubiquitous Internet access that people have got, and this is something that's very powerful in today's society. If we don't do that and individual—thousands

of individual units or localities are entitled to put on taxes, it will increase costs to users and create tremendous administrative and regulatory costs at the same time. That's probably the fundamental point.

There are many policy reasons now why we're pushing, for example, for broadband rollout. This would be discouraging of that. And yet, the telecommunications industry, no matter what part of it, would tell you that they need to be pushing ahead on that type of program.

The digital divide would be enhanced by this problem. People across the country who need to get into access, mothers and fathers across the country who are not as well off want to have access to computers and access to these services. This would be a burden on them and they are the payers at the local level, your constituents, that would be put into that kind of position.

We need an economic stimulus. This has been a good economic stimulus over the years. There's no better time than now for economic stimulus and this would do that. This would be effectively a tax increase if this is allowed to expire at the end of the year and we begin to get into all these taxes. People are going to start paying more money out of their pockets than they otherwise would, and this is the worst time that we have ever seen for that.

We want to hold onto our competitive position in the world to the greatest extent that we possible can. Europe will, I assure you, take backwards steps here. That is what they do. They are going to be putting a lot of taxes on in Europe because that's what they do in Europe, and as a result of that, they're going to put themselves in a disadvantageous position to the United States. We should not follow that lead.

Furthermore, right now, you're in a good position. This is a good time. Localities are not dependent upon these taxes. Once they get dependent on it, it's very tough for Congressmen and women to say, no, let's take it back away again because of policy reasons. You're positioned well right now. If you let it expire and you let these people all get dependent upon this, it's going to be murder to try to actually perform good policy. You will be making a policy decision that will mean an increase in taxes.

I think that the Federal moratorium is sound policy. You've been doing it over and over again. The time has come to go forward with it.

So in conclusion—and I'm on time, actually—in conclusion, this information technology boom that drove the last boom in this country can provide the kind of efficiencies that will send us forward again. It will generate new wealth in America, as Congressman Kemp said. And it will empower individual people, and that's what we're trying to do in America. And it will keep tolls off the Internet.

So I believe that H.R. 49 is a good bill. It's the right time to push it forward, and you have an opportunity before this thing gets embroiled in a sales tax issue, which is of very dubious, questionable policy that is going to be thoroughly argued out, may never be completely resolved at the end of the year. At least do the right thing now on this piece of legislation.

Mr. CANNON. Thank you, Governor. We appreciate that.

[The prepared statement of Mr. Gilmore follows:]

PREPARED STATEMENT OF JAMES S. GILMORE, III

INTRODUCTION

Chairman Cannon, Congressman Watt, and Members of the Commercial & Administrative Law Subcommittee, thank you for inviting me to explain why the permanent and national prohibition against Internet access taxes proposed in H.R. 49 is critically important to the future of the United States economy and to ubiquitous access to the Internet by the American people.

Let me preface these remarks by recognizing the tremendous vision of your colleague, Congressman Chris Cox, who had the foresight over five years ago to protect the Internet from multiple and discriminatory tax burdens with passage of the Internet Tax Freedom Act of 1998. Without the Internet Tax Freedom Act, I doubt our Nation would be as advanced as it is today in terms of widespread Internet access, broadband rollout and international dominance of electronic commerce and the exchange of information and digital content on-line.

I also would like to recognize Senator Allen and Senator Wyden for their efforts in the Senate to move tax freedom for Internet access forward. And, of course, I would like to acknowledge President Bush and Vice President Cheney for the Administration's strong support for a permanent federal prohibition against taxes on Internet access.

HISTORY OF ADVISORY COMMISSION ON ELECTRONIC COMMERCE (1999–2000)

I have been blessed with several noteworthy honors in my career. The highest honor was to be elected by the people of Virginia to serve as their Governor from 1998 to 2002. In that role, I had the opportunity to pass the nation's first comprehensive Internet policy and steer Virginia's tax policy to promote Internet access and electronic commerce. I also presided over unprecedented economic growth in the Information Technology sector.

While I served as Governor, I also had the privilege to serve as the Chairman of the Advisory Commission on Electronic Commerce from 1999 to 2000. The Advisory Commission on Electronic Commerce was established by Congress to conduct a thorough study of federal, state, local and international taxation of electronic commerce. Speaker Hastert asked the Commission to send "sound policy proposals for the individual taxpayers of America," and former Senate Majority Leader Lott requested us to forward "a clear and unambiguous policy proposal, especially if that proposal is bold and innovative." For nearly a year, 19 Commissioners and their staffs devoted their creativity and thousands of hours of work deeply engaged in that endeavor.

The Commission's membership was comprised of distinguished leaders, from both the public and private sectors, representing diverse perspectives on the issue Internet taxation.

They included several distinguished leaders from the private sector: Michael Armstrong of AT&T, Grover Norquist of Americans for Tax Reform, Richard Parsons of Time Warner, Bob Pittman of AOL, David Pottruck of Charles Schwab, John Sidgmore of MCI WorldCom and UUNet, Stan Sokul on behalf of the Association of Interactive Media, and Ted Waitt of Gateway. And they included an equally impressive group from the public sector representing state and local governments: Dean Andal, Chairman of the California Board of Equalization, Delegate Paul Harris of the Virginia General Assembly, Commissioner Delna Jones of Washington County, Oregon, Mayor Ron Kirk of Dallas, Texas, Governor Mike Leavitt of Utah, Gene LeBrun of the Commissioners on Uniform State Laws, and Governor Gary Locke of Washington State. And representing the Clinton-Gore Administration were Joe Guttentag of the Department of Treasury, Andy Pincus of the Department of Commerce, and Bob Novick of the Office of U.S. Trade Representative.

In nearly a year of work and four two-day meetings and several remote teleconference meetings, the Commission heard testimony from over 55 experts, academics, think-tanks and interest groups representing as broad a range of perspectives on tax and electronic commerce policy as has ever been organized into one study. Each Commissioner was able to invite his or her own experts to express a viewpoint. We heard from every quarter, from the Heritage Foundation to the National Governor's Association and Wal-Mart.

A year of robust debate yielded a sophisticated set of ideas that the Commission reported to Congress in April of 2000. I am confident that conclusions we reported to Congress represent an excellent policy blueprint that will have tangible and beneficial effects for the people of the United States. A copy of the Commission's final

Report to Congress and its library are archived on-line by George Mason University Law School at *www.ecommercecommission.org.*

ADVISORY COMMISSION ON ELECTRONIC COMMERCE'S POLICY PROPOSALS

The Internet Tax Freedom Act and H.R. 49 address two distinct tax policy issues: (1) state and local taxes on Internet access provided by a traditional Internet service provider (or "ISP"), and (2) "multiple and discriminatory" taxes that treat electronic commerce differently than any other kind of commerce. The Commission I chaired for Congress studied these two tax policies in detail and a majority of the Commission voted to extend the federal prohibition against both of these taxes.

The Commission also studied other taxes, some imposed by the federal government and others imposed by state or local governments. Before focusing my remarks on the tax question presented by the Internet Tax Freedom Act and H.R. 49, however, I would like to summarize the other distinct policy questions the Commission addressed. It suffices to note that these policies are not necessarily dependent upon one another, and each of the Commission's policy proposals should be considered on its unique merits. Certainly, resolution of H.R. 49 should not be dependent upon the policy debate over other issues such as interstate sales tax collections on the Internet.

A majority of Commissioners approved policy prescriptions that, in my view, advance the important objectives of promoting Internet connectivity and individual empowerment for the people of the United States. Among the ideas submitted in the Commission's April 2000 Report, you will find proposals for the following tax reforms:

(1) First, Congress should eliminate the 3% federal telephone tax—an immediate tax cut of over $5 billion annually for the American people. This tax was originally established as a luxury tax for the few Americans who owned a telephone to fund the Spanish American War of 1898. Since that time, it has been scheduled for extinction for decades, but was finally made permanent in the late 1980s. In the Information Age, it is important to stop taxing people's telephones. Elimination of this regressive tax is an important first step in reducing the expense of Internet access, one of the contributing factors to the digital divide. While this tax once was justified as a luxury tax on the few Americans who owned a telephone, it has no rationale in the Information Economy.

(2) Second, extend the current moratorium on multiple and discriminatory taxation of electronic commerce for an additional five years through 2006.

(3) Third, prohibit taxation of digitized goods sold over the Internet. This proposal would protect consumer privacy on the Internet and prevent the slippery slope of taxing all services, entertainment and information in the U.S. economy (both on the Internet and on Main Streets across America). Moreover, this tax prohibition is essential to maintaining U.S. global competitiveness since the United States currently dominates the world market in digitized goods.

(4) Fourth, make permanent the current moratorium on Internet access taxes, including those access taxes grandfathered under the Internet Tax Freedom Act. This proposal is another crucial initiative, targeted to reduce the price of Internet access and to close the digital divide. By expanding the moratorium to eliminate the current grandfather provision, consumers across the country would participate in electronic commerce without onerous tax burdens.

(5) Fifth, establish "bright line" nexus standards for American businesses engaged in interstate commerce. The cyber economy has blurred the application of many legal nexus rules. American businesses need clear and uniform tax rules. Therefore, Congress should codify nexus standards for sales taxes in a way that adapts the law of nexus to the New Economy and the new "dot com" business model. Codification of nexus would serve several important policy objectives: (1) provide businesses "bright line" rules in an otherwise confusing system of state-by-state nexus rules; (2) protect businesses, especially small businesses, from onerous tax collection burdens; (3) reduce the amount of costly litigation spurred by confusing nexus rules; (4) nurture the full growth and development of electronic commerce; and (5) give consumers and individual taxpayers who participate in Internet commerce a tax break.

(6) Sixth, place the burden on states to simplify their own labyrinthine telecommunications tax systems as well as sales and use tax systems to ease

burdens on Internet commerce. This effort will be particularly important for small and medium-sized retailers with nexus in two or more states. It also will be important for telecommunications companies as they build out the Internet infrastructure and offer new technologies and services. Radical simplification will be necessary in the New Economy if small and medium-sized businesses are to succeed.

(7) Seventh, clarify state authority to spend TANF funds to provide needy families access to computers and the Internet, as well as the training they need to participate in the Internet economy. This is one strategy the Commission formally recommends to close the digital divide and make the personal computer and access to the Internet as ubiquitous as the telephone and television.

(8) Eighth, provide tax incentives and federal matching funds to states to encourage public-private partnerships to provide needy citizens access to computers and the Internet. This is yet another strategy the Commission formally recommends to close the digital divide.

(9) Ninth, respect and protect consumer privacy in crafting any laws pertaining to online commerce generally and in imposing any tax collection and administration burdens on the Internet specifically. This is a formal recommendation of the Commission.

(10) Ten, continue to press for a moratorium on any international tariffs on electronic transmissions over the Internet. This idea also is a formal recommendation of the Commission.

(11) And eleven, a majority of the Commission endorsed a comprehensive framework for addressing international tax and tariff issues based upon the following core principles: no new taxes or tax structures on electronic commerce in the world marketplace; tax neutrality toward electronic commerce; simplicity and transparency of tax rules applied to electronic commerce; and a call for the Organization of Economic & Community Development (OECD) to continue fostering international dialogue and cooperation on international tax issues.

It is important to note that the Commission's study of the Internet Tax Freedom Act and its prohibitions against taxes on Internet access and multiple and discriminatory taxes targeting electronic commerce elicited little if any controversy. And there was consensus that the national goal of any policy addressing the Internet should be to promote ubiquitous access. Those issues only became controversial in the context of political bargaining over other, more controversial topics.

BACKGROUND ON INTERNET TAX FREEDOM ACT (1998)

When Congress passed the Internet Tax Freedom Act in 1998, it was difficult to predict, or even catalogue, the many policy dimensions of federal, state and local taxation of Internet access and Internet-based commerce. Mindful of the axiom to do no harm, Congress acted cautiously in the beginning:

(1) First, Congress prohibited state and local taxes targeting Internet access temporarily, for three years, so that the ramifications of the federal prohibition could be measured;

(2) Second, Congress "grandfathered" about ten states that already had enacted some form of state or local tax on Internet access to allow them time to reverse their policies in light of countervailing federal policy without any dramatic revenue impact and/or to keep their policies in place in the event Congress might eventually reverse national policy; and

(3) Third, Congress established the Advisory Commission on Electronic Commerce to study Internet tax policies and report back to Congress on its deliberations, policy debate and majority proposals, as well as any formal findings or recommendations that could garner a supermajority.

Congress wanted to move forward deliberatively and carefully because the Internet economy and all of its dimensions were not fully understood. Yet, Congress needed to act quickly because state and local governments already had begun to target Internet access services, websites and content under disparate and often illogical tax theories.

Tacoma, Washington, for example, implemented a plan in September of 1996 to tax Internet Service Providers as telephone utility companies (a law the state legislature later repealed). Wisconsin enacted a 5% sales tax on Internet access, subjecting its taxpayers to two taxes to log on the Internet—a tax on their telephone

service used to dial up the Internet and a second tax on their Internet service. Connecticut, on the other hand, started taxing Internet access at 6% under the theory that it constituted a "computer and data processing" service (Connecticut terminated the tax in 2001). New Mexico began imposing a gross receipts tax Internet access and continues to this day. Even small towns, like Chandler, Arizona, started imposing local utility taxes on Internet access service in the mid to late 1990s.

The real threat of hundreds if not thousands of differing tax theories, rates, jurisdictions, audits and regulations getting heaped upon Internet access the way it had local and long-distance telephone service spurred Congress to enact a federal moratorium against the proliferation of such taxes. Congress grandfathered the handful of states that had started taxing Internet access.

The grandfather provision implicitly told those states that had rushed to tax Internet access that Congress disapproved of the imposition of a myriad of state and local tax burdens (including both the costs of taxes as well as the costs of regulatory compliance, audits and collection) upon inherently interstate Internet access services. These grandfathered states faced a choice. They could either reverse their hasty decisions to tax Internet service or they could wait to see if Congress might change its mind.

Since its original enactment in 1998, several states have dismantled or significantly curtailed their taxes on Internet access. Texas, for example, eliminated its tax on Internet access priced below $25 per month. Connecticut decided to phase out its tax on Internet access altogether. Washington State repealed the local tax on Internet access that the City of Tacoma had imposed.

In 2001, Congress voted overwhelmingly a second time to extend the federal prohibition an additional two years to 2003, endorsing once again a national policy of promoting ubiquitous Internet access by prohibiting onerous tax and regulatory burdens on access.

AVOIDING THE CONSUMER TELEPHONE TAX LABYRINTH ON THE INTERNET

We now approach the conclusion a five-year federal moratorium on Internet access taxes and Congress faces a fundamental policy choice:

(1) Should Congress adopt the policy that myriad state and local tax burdens on Internet access are antithetical to an enduring national policy of promoting ubiquitous and competitive Internet access by making the moratorium on access taxes permanent and universal across all states?

(2) Or should Congress reverse course, eliminate the federal prohibition, and allow state and local governments to proceed to tax Internet access as they see fit?

I believe the policy goals and purposes that justified Congress' original adoption of the Internet Tax Freedom Act in 1998 are equally compelling today and justify a permanent and universal prohibition against taxes on Internet access throughout the United States.

Abolishing the federal prohibition would force the Internet superhighway to navigate the same labyrinthine maze of overlapping and disparate state and local tax regulations and burdens that currently strangles the Nation's telecommunications services. Presently, a national telecommunications service provider might be required to file as many as 55,000 different tax returns each year to comply with the tax burdens of all state and local jurisdictions. The effective transaction tax rates that apply to telecommunications services exceed the effective transaction tax rates applied to almost all other sales. Average effective state and local tax rates average about 14% as compared to 6.3% for most other sales. When all state, local and federal telephone taxes and fees are counted, it is not uncommon for 20% or more of a consumer's telephone bill to be taxes.

Also, many state and local governments apply different tax structures and tax rules and bases depending upon the type of telecommunications services. In one jurisdiction, different tax rates might apply to telecommunications services provided by traditional wire line, cable, Internet, or wireless firms. Companies that offer essentially the same services over different technological media often are uncertain regarding the appropriate tax treatment of their service.

These transaction taxes are complex and compliance is costly. Telecommunications service companies bear the compliance costs for calculating, collecting, auditing and remitting these taxes, and these burdens are prohibitive for small telephone companies. More importantly, individual consumers pay these exorbitant taxes. Thus, the taxes not only impose significant costs and burdens on businesses, but they significantly increase the cost of using the telephone in an Information Society where citizens who are elderly, poor and shut-in must have a telephone.

Regardless of one's perspective regarding whether telephone service should or should not be taxed, or at what rate, I do not believe anyone asked to design an interstate telephone tax structure on a blank slate would craft the kind of disparate, complicated and costly system we have in place now. It's too complex, it's regressive, and it's a drag on the telecommunications infrastructure and connectivity in America. We can't let that happen to Internet access too.

But that is precisely the tax structure being proposed by opponents of H.R. 49. If Congress does not pass H.R. 49, small independent Internet service providers will face the immediate prospect of filing dozens or perhaps hundreds of tax returns and remittances each year. The large national Internet service providers will face the daunting task of filing 50,000 each year. The big ones might be able to hire the administrative overhead, accountants and lawyers to manage that task, and pass the cost to their customers in higher prices. But many small ones would never be capable of competing in such an environment.

It is imperative that Congress enact a permanent and national prohibition against state and local taxes on Internet access to prevent Internet access, the industry that provides access to the Internet, and the individual citizens who log on the Internet from the detrimental effects of a telephone-like tax system.

WHY CONGRESS SHOULD ENACT A PERMANENT & NATIONAL PROHIBITION AGAINST INTERNET ACCESS TAXES

Moreover, there are numerous compelling policy rationales for a permanent and national prohibition against Internet access taxes.

(1) It should be the National Policy of the United States to promote freedom and ubiquitous Internet access and connectivity in America. The economic, social and political benefits are great. The potential for individual empowerment is tremendous. We should not inhibit the full outgrowth and ubiquitous access to the Internet by allowing onerous tax burdens to slow down the Internet superhighway. Taxes would inhibit full outgrowth in several ways: (1) by increasing the cost to users and (2) imposing significant new administrative and regulatory costs upon Internet access providers.

(2) The federal government and many state and local governments are subsidizing Internet access and broadband rollout in many regions of the United States. It would be counterproductive to then take back the subsidies through burdensome taxation of the very services we subsidized. For example, North Carolina has established the North Carolina Rural Internet Access Authority. The Authority's mission is to wire rural communities throughout North Carolina in partnership with local telephone companies. North Carolina has provided over $30 million in public funds to support the project. The U.S. Department of Agriculture's Rural Utilities Services makes direct grants totaling in the tens of millions of dollars to wire rural communities and small towns. U.S.D.A. also implements the Rural Broadband Loan and Loan Guarantee Program Rural Utilities Service (RUS) which, this year, will make over $1.4 billion in government-subsidized loans and loan guarantees available to companies deploying broadband service to communities of less than 20,000 people.

(3) Small, independent and rural Internet Service Providers (ISPs) will be at a competitive disadvantage in rolling out access across local and state boundaries if multiple state and local taxes and their attendant regulatory and compliance burdens are imposed. They can't compete with the big national ISPs in complying with regulatory and administrative burdens. This would reduce choice for rural consumers and force them to higher-cost services.

(4) America still suffers from digital divides—rich vs. poor, urban vs. rural, white vs. black, educated vs. uneducated, young vs. old. Taxes will only widen these divides at a time when our goal should be to make the personal computer and Internet access as affordable and ubiquitous as the telephone and television. According to the U.S. Department of Commerce's report, A Nation Online (February 2002), large disparities remain in Internet usage rates between certain classes of citizens. The access gap between citizens with incomes over $75,000 versus those making less than $15,000 grew from 35% in 1997 to 54% in 2001. The gap between white and black citizens expanded from 12% in 1997 to 20% by September 2001. We still have a way to go to close these gaps. Imposing tax burdens that increase

consumer costs and reduce competition among ISPs would be counterproductive.

(5) We need continuous economic stimulus to spur economic activity and investment, especially in the e-commerce and technology sectors. A permanent moratorium will be a positive signal to investors and Internet entrepreneurs.

(6) Failure to extend the moratorium is effectively a tax increase on American consumers who have Internet access in their homes and offices. An economic downturn is the worst time for a tax increase. For example, if Congress lifted the moratorium and allowed states and localities to tax Internet access pursuant to their telecommunications tax rates, a consumer paying $20 per month for Internet access might pay, in an average state, an additional $3 per month and $36 per year just to log on the Internet.

(7) The federal prohibition prevents double taxation of ISP service as well as taxation of the phone and cable lines people use to access their ISP. For many consumers, the $36 noted above would duplicate taxes already paid for a local telephone line.

(8) America currently dominates the world market in electronic services, software development and digital content. We should strive to build on our competitive position even further. Tax policy favorable to Internet access and the content and information transferred over the Internet is critical to maintaining our competitive position in the world marketplace. Europe is looking for more ways to tax the Internet and the content, software and information exchanged over the web. We should resist the European paradigm of imposing VAT taxes on Internet service and the content and information accessed over the Internet.

(9) States and localities are not currently dependent upon Internet access taxes because Congress enacted the moratorium in 1998. The few states that enacted access taxes before 1998 are not heavily dependent upon the revenues. In fact, since enactment of the Internet Tax Freedom Act (ITFA) in 1998, many states trended away from access taxes. Texas, Connecticut and Washington State are good examples. Yet, what we do know from experience in the states that enacted these taxes prior to 1998 is that their tax rules are unclear and difficult to administer. Nevertheless, states with Internet access taxes have been provided five years of clear notice that national policy disfavors these taxes.

(10) There is a general consensus that the federal moratorium is sound policy. Congress has passed it twice (1998 and 2001). Even in the ACEC, the moratorium on access taxes was not controversial. And in the nearly ten years that I have been working on policies regarding information technology, the Internet, economic growth, electronic commerce and state and local taxes, I have never heard anyone articulate a thoughtful reason for why a panoply of state and local taxes on Internet access would be sound or constructive policy for the people of the United States.

CONCLUSION

The Internet is the most transforming economic development since the Industrial Revolution. Information Technology drove America's economic boom in the late 1990s, it has buoyed the economic slowdown, and it will lead our economic resurgence. It created new jobs, increased our National productive and efficiencies in every sector of the economy, and generated new wealth in America. Even in rural areas long ago ignored by the economic progress in metropolitan areas and bypassed by the Nation's huge investment of public resources on the interstate highway system, small businesses are prospering by selling products worldwide on the Internet and American consumers have been able to obtain everything from information and educational opportunities to goods and services otherwise beyond their reach. Every person on the Advisory Commission on Electronic Commerce recognized that our national economy, U.S. global competitiveness, and American culture depend vitally upon nurturing full development of the Internet.

Most importantly, the Internet and the personal computer have empowered individual people as citizens in a democracy, as consumers, and as entrepreneurs in unprecedented fashion.

America can embrace these positive developments and promote more of it by keeping taxes and regulatory burdens on Internet access to a minimum, or it can thwart them by taxing Internet access. I would urge Congress to keep tolls off the Internet superhighway by passing H.R. 49.

Mr. CANNON. I'd like to introduce now Mr. Harley Duncan, our third witness. He's the Executive Director of the Federation of Tax Administrators and has been that since 1988. Organized in 1937, the FTA is an association representing the principal State revenue collection agencies in each of the 50 States, the District of Columbia, and New York City. The mission of the Federation is to improve the quality of State tax administration by providing services to State tax authorities and administrators.

Prior to joining the FTA, Mr. Duncan served for 5 years as Secretary of the Kansas Department of Revenue. He also held positions as Assistant Director of the Kansas Division of the Budget, with the South Dakota State government, the Advisory Commission on Inter-Governmental Relations, and the National Governors Association.

Mr. Duncan is the author and co-author of a number of articles and papers on State and local taxation and public budgeting. He's a frequent speaker at State and local tax conferences and meetings. Mr. Duncan holds a bachelor's degree from South Dakota State University and a master of public affairs from the University of Texas.

Mr. Duncan, welcome and thank you for being with us here today.

STATEMENT OF HARLEY T. DUNCAN, EXECUTIVE DIRECTOR, FEDERATION OF TAX ADMINISTRATORS

Mr. DUNCAN. Thank you very much, Mr. Chairman. It's a pleasure to be here.

The policies of our Federation with respect to H.R. 49 or the matters covered by H.R. 49 are laid out in the statement before you and were adopted by our Members at the annual meeting in 2001. I think I'd like to make five points relatively quickly this morning with respect to this.

The first is that while we will raise questions about H.R. 49 and continuation of the Internet Tax Nondiscrimination Act, that should not be interpreted, I think, as an intent to impede the deployment of the Internet or to deny anyone the access to Internet services. That's certainly not the intent of the Federation of Tax Administrators or State governments generally. States have made significant efforts in trying to aid the deployment of the Internet services and tax administrators are probably the leaders in bringing e-Government services, so that's certainly not our intent.

The second point I would make is that raising questions about H.R. 49 shouldn't be interpreted that we are in some fashion supportive of multiple and discriminatory taxes on electronic commerce or on any sort of commerce. The questions that we'd raise are simply, is this the correct vehicle for doing it and is it the most effective vehicle for doing it, and more importantly, does the bill itself provide anything that the Constitution doesn't already provide in terms of preventing multiple and discriminatory taxes, because that, in our estimation, is where the most effective protections and the appropriate constraints on State and local taxation exist, is in the U.S. Constitution.

The third point that we would make is this, that as the Committee considers extending the Internet Tax Nondiscrimination Act,

it's an excellent point in time to go back and examine whether the purposes that gave rise to the act still exist and whether the act is appropriately meeting those particular purposes. If you recall, in 1998, there were, as I recall, two reasons given for the need to pass the Internet Tax Freedom Act. The first was that the Internet was what was commonly referred to as a fledgling industry at the time and that it needed time to grow up before it would be considered a part of mainstream commerce and perhaps subject to the impositions of taxes that other forms of commerce are. I think the time that in the past 5 years has proved that the Internet is not a fledgling industry. While it is subject to considerable change, it continues to do well and, in fact, outperformed normal means of commerce.

The second reason given was that States would rush to impose a variety of multiple and discriminatory and other types of taxes on the Internet. I think that was misplaced and misfounded at the time, and one piece of evidence would be that, to my knowledge, there's been no single case before a court where the Internet Tax Freedom Act or the Nondiscrimination Act has been raised as a defense to something that the States are involved in.

As a second matter, I would urge you, if you do extend the act, to do so for a temporary purpose, for a period, because there are issues that will remain that should be examined periodically if the act is put in place.

The fourth point that I'd make and the one that I'd like you to pay particular attention to is the need to examine the definition of Internet access that is in the bill and to consider changes to it. There are really three issues that are created by the current definition of Internet access.

The first is, it discriminates among certain types of providers of Internet access. It said the current definition specifically excludes telecommunication services from Internet access and that then causes certain telecommunication providers that bundle access in telecommunication service providers and treats them differently than those who would provide Internet service using normal telecommunications.

The second thing it does is to discriminate against people that provide content without access because the access definition is so broad that a wide range of content can be bundled with it and receive the tax exemption.

The third problem with the current definition is it allows for an erosion, an unintended erosion, of State tax bases because of the content that can be bundled with the access and, therefore, considered exempt.

The fourth point I'd make to you is that H.R. 49—or the last point, I'm sorry, is that H.R. 49 would repeal the grandfather clause that was originally enacted in 1998. We would oppose that and encourage you not to do that. Those States, it would disrupt the revenue system of those nine States, including States such as Texas, Wisconsin, North Dakota, South Dakota, Tennessee, and several others. It would constitute an unfunded intergovernmental mandate, and there's been no showing that the tax on access either reduces the utilization of access services or creates any administra-

tive burden and we would encourage you not to repeal that grandfather originally contained in the bill in 1998. Thank you.

Mr. CANNON. Thank you, Mr. Duncan. We appreciate that, those comments.

[The prepared statement of Mr. Duncan follows:]

PREPARED STATEMENT OF HARLEY T. DUNCAN

My name is Harley T. Duncan. I am the Executive Director of the Federation of Tax Administrators. The Federation is an association of the principal tax administration agencies in each of the 50 states, the District of Columbia and New York City. We are headquartered in Washington, D.C.

The policies of the Federation are established through resolutions adopted by the members at the Annual Meeting or by action of the 18-member Board of Trustees. The Federation has adopted two policy statements relevant to the issue at hand:

- Resolution 18 adopted in 2001 is a general policy statement that urges the Congress and U.S. government agencies to refrain from enacting measures, taking actions or making decisions which would abrogate, disrupt or otherwise restrict states from imposing taxes that are otherwise lawful under the U.S. Constitution or from effectively administering those taxes.
- Resolution 22 adopted in 2001 states that if Congress determines to extend the provisions of the Internet Tax Freedom Act, it should do so in accord with the following parameters:
  - The Act should be extended for not more than five years to insure that its impact on state and local revenues is examined periodically and that unintended consequences are not occurring.
  - Any extension of the Act should preserve the ability of those states currently imposing a tax on charges for Internet access to continue to do so if they so choose.
  - The definition of Internet access contained in the Act should be rewritten in such a manner that it does not create avenues to bundle otherwise taxable content, information and services into a single package of Internet access in a manner that would prevent states and localities from imposing their taxes on the otherwise taxable content, information and services.
  - The definition of discriminatory taxes contained in the bill should be amended to insure that it does not create a situation in which a seller could avoid a tax collection obligation in a state even though the seller has a substantial nexus in the state.

EXTENSION OF THE ACT

As a general proposition, FTA opposes federal legislation that preempts the authority of states to structure and administer their taxes within the confines of the U.S. Constitution unless there is a compelling showing of unfairness, compliance or economic harm from the manner in which that power is being exercised. The Internet Tax Freedom Act was originally passed in 1998 (and renamed the Internet Tax Nondiscrimination Act and extended for two years in 2001) to provide the new electronic commerce industry with short-term protection from what some thought could become a burdensome and discriminatory system of state and local taxation. Any consideration of extending the Act should be accompanied with a re-examination of this stated purpose.

We would submit that the "fledgling industry" argument is no longer relevant. Electronic commerce is becoming a mature and important part of the U.S. and international economy. In particular, the continued prohibition on the imposition of new taxes on charges for Internet access should be evaluated. In our estimation, there has been no showing that the purchase or supply of Internet access services in the states that tax the services has been adversely affected. Neither has there been a showing of an undue compliance burden on Internet service providers that would justify the preemption. Continuing the preemption simply provides a special position for this particular communications medium. As discussed below, the preemption is beginning to discriminate among firms in the Internet access and communications sector.

We also believe it is clear that concerns about states rushing to impose burdensome taxes on the electronic commerce sector were misplaced and unfounded. While states have had to determine the manner in which existing taxes should be applied to Internet services and electronic commerce, there was no headlong rush to devise

new schemes of taxation that in some fashion targeted the electronic commerce industry. To the contrary, states have worked diligently to provide incentives to the Internet service industry and to consumers in efforts to increase access to Internet services. To my knowledge, the Internet Tax Nondiscrimination has not been used as a defense in a single reported case involving the application of state taxes to electronic commerce.

In short, we would urge the Committee to examine closely the continued need for a federal law governing the subject matter covered by the Internet Tax Nondiscrimination Act.

GRANDFATHER CLAUSE

H.R. 49 would repeal the **"grandfather clause"** in the current Internet Tax Moratorium that preserves state taxes on charges for Internet access that were in place in 1998 when the original Internet Tax Freedom Act was enacted. The Federation opposes a repeal of the grandfather clause.

- According to our records, nine states currently impose taxes that are protected—New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Tennessee, Texas, Washington and Wisconsin. Repealing the grandfather would disrupt the revenue stream of these states at a time when nearly every state is struggling to balance its budget. Repealing the preemption would constitute an intergovernmental mandate under the Unfunded Mandate Reform Act.
  - The taxation of charges for Internet access is a legitimate exercise of state taxing authority and should not be preempted. In most of those states currently taxing access, the tax is consistent with their overall policy of taxing most (or at least a large number of) service transactions. The tax on access charges can in no way be considered a "money grab" by the states, but is instead a simple extension of their existing tax policy.
  - There is no showing that the imposition of taxes on charges for Internet access has affected the growth of electronic commerce or the Internet industry. Neither is there any showing that administration of the tax on charges for Internet access has imposed undue burdens on the industry or has in any other way proved to be incapable of being administered.
  - The grandfather clause was part of the terms of the original Internet Tax Freedom Act. If the other parts of the Act are to be continued, there has been no demonstration of why the grandfather clause should not be continued.

DEFINITION OF INTERNET ACCESS

The **current definition of Internet access** has not kept pace with the manner in which the electronic commerce has evolved and discriminates among various types of Internet service providers. It should be amended to insure equity among various types of access providers and among types of communications services. It should also be amended so as to avoid an unintended erosion of state tax bases.

- The Act's current definition of Internet access is "a service that enables users to access content, information, electronic mail, or other services offered over the Internet, and may also include access to proprietary content, information, and other services as part of a package of services offered to users. Such term does not include telecommunications services."
- The current definition effectively allows a broad range of content and other services to be bundled with Internet access and potentially be considered as protected under the prohibition on the imposition of new taxes on Internet access. The range of content and service that can be bundled with Internet access is virtually unlimited. It includes all manner of printed material, video material, voice communications and other services.
- By excluding "telecommunications services" from the definition of access, the act discriminates against some telecommunications services providers (particularly wireless providers) that provide access as part of a package of telecommunications services and therefore cannot exclude a portion of the total charge from taxation.
- Firms that are providing content, voice, video, or other services that compete with those provided by Internet service providers will face a discriminatory and unfair competitive situation if those services when provided as part of Internet access are protected from state and local taxation, but services provided outside a bundle that includes access are subject to state and local

taxes. The convergence of technologies, the advent of services such as Internet telephony, and the consolidation in the communications industry suggest that this discrimination will be a real issues "sooner rather than later."

- The current definition allows a growing proportion of the state and local tax base to be effectively put "off limits" by federal legislation with such a broad definition of Internet access. We do not believe this was the intent of Congress when it originally passed the Internet Tax Freedom Act three years ago.
- By attempting to provide protection to one industry and one type of service provider, Congress has necessarily established a regime that discriminates against similar service providers that are not also Internet access providers. This was perhaps not a major issue when the Act was originally passed 4½ years ago. However, with the advent of advanced forms of access, the convergence of technologies and the realignment of businesses within the communications and entertainment industry, the definition of Internet access is on the cusp of creating serious discrimination and base erosion issues.
- Congress must in any consideration of extending the Internet Tax Nondiscrimination Act reconsider the definition of Internet access to insure that it does not discriminate and does create consequences beyond what was intended.

SUGGESTED DEFINITION

The issue then is how to define Internet access in a fashion that achieves the Congressional goal of protecting access to the medium of the Internet without being so broad as to create the inequities and distortions described above by including all the services and products that may be accessed via the Internet. This is a difficult task.

- One approach for Congress to consider is a variation of the approach taken by the state of Texas, which exempts up to $25 of a bill for Internet access (under current law.) We would suggest deeming a set dollar amount of each bill from an Internet service provider to be attributable to exempt Internet access, while the rest of the bill is deemed to be attributable to other services that may or may not be taxable, depending on the laws of the specific state. Possible language for such a provision is available on request.
- The only other workable alternative would be to require Internet service providers to state separately the charges for each particular service sold as part of the access package. We believe such an approach could be burdensome for the providers and lead to a number of disputes regarding the manner in which the charges are disaggregated.
- If Congress is not comfortable adopting the "modified Texas approach" outlined above, we would strongly encourage it to establish at the outset some mechanism to examine and respond to the issues of bundling and convergence. It should, at a minimum, commission an examination of the nature of the issue, expected near-term technological developments, and alternatives for addressing the issue.

DEFINITION OF DISCRIMINATORY TAXES

The definition of discriminatory taxes contained in the Act provides that certain activities when performed by an Internet service provider on behalf of a retailer will not be considered in determining substantial nexus for tax collection purposes. Any extension of the moratorium should examine these issues carefully.

- The provisions were intended to insure that merely accessing products of an out-of-state seller via an in-state service provider would not be considered to create nexus for the out-of-state seller. When enacted as part of a short-term moratorium, these provisions were not considered problematic.
- The definition, when read in conjunction with other provisions, could be interpreted to allow a seller to avoid a collection obligation even though it has substantial activities and presence in the state. As the electronic commerce industry has evolved, the potential for this issue to arise has grown.
- If the Internet Tax Nondiscrimination Act is to be extended, however, these provisions should be examined carefully.

CONCLUSION

- Any extension of the Internet Tax Nondiscrimination should be accompanied by a serious examination of its actual consequences and an assessment of whether it is needed in the future.

- There has been no showing of a reason to repeal the grandfather clause. Any extension should preserve the right of those affected states to continue to impose taxes on charges for Internet access.
- Any extension of the Internet Tax Nondiscrimination Act should include amendments to the definition of Internet access that will insure that it is nondiscriminatory among types of service and content providers and will not unintentionally erode state and local tax bases.
- Any extension of the Internet Tax Nondiscrimination Act should also examine the definition of discriminatory tax to insure that it does not have unintended consequences.

Mr. CANNON. Our final witness is Mr. Harris Miller, President of the Information Technology Association of America. The ITAA is the largest and oldest information technology trade association, representing over 400 leading software services, Internet, telecommunications, e-commerce, and systems integration companies.

Mr. Miller leads the ITAA's public policy focus on subjects critical to the IT industry and has spoken and published widely on a variety of high-tech issues. Mr. Miller is also President of the World Information Technology and Services Alliance, an association of associations representing 50 high-tech trade groups around the world. In addition, Mr. Miller was recently appointed to the Virginia Research and Technology Advisory Commission.

Prior to joining ITAA, Mr. Miller gained broad public policy experience through his leadership roles in Government relations practices, specializing in the areas of immigration, high technology, and banking. Mr. Miller also has many years of prior Government service, including positions as the Legislative Director to former Senator John Durkin, Deputy Director of Congressional Relations at the U.S. Office of Personnel Management, and as a Legislative Assistant to the Chairman of the Subcommittee on Immigration, Refugees, and International Law of the House Judiciary Committee, the Honorable Ron Mazzoli.

Mr. Miller holds an undergraduate degree from the University of Pittsburgh and a graduate degree from Yale University. Mr. Miller, thank you for being here with us today.

STATEMENT OF HARRIS N. MILLER, PRESIDENT, INFORMATION TECHNOLOGY ASSOCIATION OF AMERICA

Mr. MILLER. Thank you, Mr. Chairman and Members of the Subcommittee. You said at the beginning you had a very distinguished panel today and I was trying to tell that to my wife last night, and she said, "I'm sure that 'my distinguished witnesses' were probably one less than you think." [Laughter.]

Mr. MILLER. Nevertheless, I do appreciate the honor to be here with Secretary Kemp, Mr. Gilmore, and Mr. Duncan to explore this important legislation, and it's a great honor to be here with now-Chairman Cox for his leadership, along with Senator Wyden, as you pointed out, Mr. Chairman, on this bipartisan legislation, H.R. 49, which ITAA and our 400 member companies strongly support.

Certainly, our major concern is that the Internet not become the tax pinata of 2003, that institutions around the country, State and local governments desperate for new revenue suddenly turn and say, how can we figure out some new sources of revenue, and even though Mr. Duncan tried to reassure the Subcommittee that there

aren't people out there looking to tax the Internet by changing definitions or changing laws.

In fact, just last week, we had—the association and another association had to file an amicus brief in Tennessee where a State tax official was trying to get a convoluted interpretation to a longstanding legislative interpretation to begin to tax Internet access charges. And so this is not a theoretical problem, Mr. Chairman. This is a real problem.

I'd also point out that Mr. Duncan said there had not been a rush to legislation. Well, I can tell you, in my 8 years at ITAA, probably no period was busier than the period right before the first Internet Tax Freedom Act was passed in terms of our rushing around the country exactly because when Mr. Cox and others took leadership on this issue, there were efforts throughout the country at the State level and the local level to try to get in under the wire and pass new taxes on the Internet or Internet access.

And so I am afraid that if this legislation is allowed to expire, in fact, we will have another rush, and I think Governor Gilmore was exactly right. Now is the time to move. Now is the time to make it permanent.

Of course, the good news is, as everyone has said, the Internet is continuing to expand. Now 150 million Americans—150 million Americans—have access to the Internet. Also, as Secretary Kemp said, the Internet is one of the crucial drivers of economic activity. The U.S. Department of Commerce says that fully one-third of all real economic growth in this country over the period 1995 to 2000 took place because of information, technology, and even though IT businesses represent only 7 percent of all businesses in this country, 28 percent of real economic growth in the late 1990's and into 2001 occurred because of the information technology industry.

Given these numbers, we don't need a crystal ball to understand how important the growth of information technology and the Internet is. All that we're saying in this legislation and all that Mr. Cox and the 88 other sponsors of this legislation in the House are saying is, the Internet does not deserve special treatment, but neither should it be an object of special discrimination.

Again, as has been said by all the witnesses and by you, Mr. Chairman, and by Mr. Cox, all we are talking about is ending permanently discriminatory multiple taxes, which even Mr. Duncan admitted is not something his organization advocated. Now, there's some ambiguity whether this is covered in the law, but if there's ambiguity, I would suggest passage of this legislation, as Mr. Cox has drafted the bill, making it permanent, is exactly the solution we need.

Secondly, this issue of imposing access to the Internet. As Governor Gilmore said quite clearly, new taxes are only going to hurt those who can least afford the ability to access the Internet. Those are the people who have not yet crossed that digital divide and taken advantage of the digital opportunity of the Internet, and those were exactly the people that this Congress should be encouraging to get on the Internet.

In fact, every day, Members of Congress are trying to do that, especially in broadband. Again, we have widespread support, bipartisan support in Congress, for higher adoption rates of broadband

access. If we start seeing States and localities trying to impose new taxes, increasing the cost of Internet access and broadband access, we are going to see the rate of broadband adoption slow rather than increase, and will be in the ironic position of Congress, on the one hand, saying we want to promote broadband adoption because it is such an economic driver, because it does give people access to e-health and e-education and e-Government, and on the other hand saying, by the way, in the process of doing so, we're going to make it more expensive for you to do that. That is exactly at the heart of the Cox-Wyden legislation, H.R. 49, and another reason why this legislation must be passed.

Another point that Mr. Duncan made which I would like to respond to is that, somehow, the way the Internet access definition is included in this legislation would be discriminatory among certain types of companies. Well, I represent all types of companies, content companies, Internet service providers, telecommunications firms, and believe me, if they thought there were discriminatory problems in this language, they would be up here speaking to the Subcommittee if they though there were real problems. So with all due respect to the previous witness's testimony, if there were really such a problem as he has tried to posit to this Subcommittee, then I think you would be hearing from the companies themselves who felt they were being discriminated against rather than just hearing from another witness.

So in sum, this is a critical legislation to drive more people onto the Internet. It's critical to prohibit permanently both the Internet access charges and the multiple discriminatory taxes, and ITAA and its members stand ready to work with you, Mr. Chairman, and the sponsors of this legislation to see Congress pass this legislation as quickly as possible. Thank you very much.

Mr. CANNON. Thank you, Mr. Miller.

[The prepared statement of Mr. Miller follows:]

PREPARED STATEMENT OF HARRIS N. MILLER

INTRODUCTION

I am Harris N. Miller, President of the Information Technology Association of America (ITAA), representing over 400 companies in the information technology (IT) industry—the enablers of the information economy. Our members are located in every state in the United States, and range from the smallest IT start-ups to industry leaders in the custom software, services, systems integration, telecommunications, Internet, hardware, and computer consulting fields. Together they account for over 90% of all IT sales in the US. These firms are listed on the ITAA website at *www.itaa.org*.

ITAA appreciates the opportunity to express our Association's strong support for the legislation being considered today, H.R. 49, the Internet Tax Nondiscrimination Act, to extend permanently the tax moratorium on Internet access services and, from a tax fairness perspective, to preserve a level playing field for companies involved in electronic commerce. I commend the Subcommittee for holding this hearing today because much is riding on your deliberations. And I commend Congressman Christopher Cox (R-CA) and Senator Ron Wyden (D-OR) for their continued leadership in this area.

The good news is that the Internet is strong and growing stronger. Over 150 million people in the United States use the Internet, a number that has tripled since 1997. According to the World Information Technology and Services Alliance and IDC, Internet commerce per capita in the U.S. rose from $295 in 1999 to $983 in

2001.[1] Over 600 million around the world now access the Internet, more than twice the number just two years ago.

The bad news is that the tech sector has been rocked in the past two years and Internet commerce is not growing nearly as fast as anyone had predicted, with dotcoms and telecoms at the leading edge of a downward plunge in IT spending growth and capital investment. In fact, most of the analysis of Internet growth from years ago showed predictions that even then were laughable, and now are just clearly horribly wrong. Double-digit increases in business spending on IT have been cut to single digits and even gone negative in some customer sectors. CEOs and CFOs are taking a far more cautious approach to new system investments. Technology refreshment cycles are being stretched over longer periods. And the pressure to look overseas for better labor rates and fatter margins is growing.

Why should our lawmakers care so much about the health of the IT industry? The IT industry has contributed to U.S. economic growth in critical ways. According to the Department of Commerce, the IT industry accounts for a full one-third of all real economic growth and half of all productivity growth between 1995 and 1999. IT has helped the economy contain inflation with average annual computer price declines of 26 percent between 1995 and 1999. During each of

the previous eight recessions, productivity growth turned negative. During the economic downturn of 2001, productivity growth remained robust at about 2%, jumping 5.2% in the 4th quarter of 2001[2] and continuing at 5.1% in third quarter 2002, in large part due to the contribution of IT.[3] And, while IT-producing industries represent only 7% of all businesses, they accounted for roughly 28% of overall real economic growth between 1996–2000.[4]

Given these numbers, we do not need a crystal ball to predict that the future of the IT industry, the Internet and the U.S. economy overall are linked—and that the steps you take in terms of Internet taxation will have far reaching consequences for the American people.

My message is simple and straightforward. The Internet does not deserve carve outs or special treatment. Neither does it deserve to become the tax piñata of 2003, hit by every revenue starved taxing jurisdiction in the country.

ITAA believes the Internet tax moratorium should be made permanent because it promotes across the board fairness, not special advantages for one group over another. Contrary to popular belief, the moratorium does not affect the ability of states to collect sales and use taxes. *The Moratorium prohibits states 1) from imposing multiple and discriminatory taxes on electronic commerce and 2) from imposing taxes on Internet access.*

So, using this same logic, let me partition my arguments into two groups: fairness and access.

If Congress does not act, the situation will revert to where it was years ago where different rules could apply based only on either the means of delivery of the product (electronic instead of tangible) or based on the means in which an order is placed (via an Internet Web site instead of by calling a 1–800 number or even over the counter). For instance, states would be free to levy discriminatory taxes on the online delivery of goods, such as "newspapers," which are explicitly exempt from sales and use taxes if delivered over-the-counter, just as they started to do in the years before the original Act was put in place.

Allowing the moratorium to lapse will also set the stage for discrimination in terms of delivery mode. Currently, out of state sales conducted by 800 number, mail order or electronic commerce are not subject to mandatory collection of sales tax by the merchant because of Supreme Court decisions. Rather the consumer is obligated to remit the same amount of sales tax directly to the state of the product's use. Changing standards for the Internet, which could happen if the moratorium is not extended, makes no sense and is not fair. To be clear, I am saying that any move to impose taxes must be done in a manner that is fair to all parties, regardless of business model or delivery mode.

So how do we accomplish fairness? First, pass the Constitution's test for moving forward. Supporting the view of the U.S. Supreme Court, ITAA believes that the states must simplify their tax systems and provide bright line business activity tax nexus standards before seeking the authority to require remote sellers to collect sales tax on their behalf.

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[1] Digital Planet 2002, the Global Information Economy, February 2002

[2] Remarks by Bruce P. Mehlman , Assistant Secretary for Technology Policy, United States Department of Commerce, April, 2002

[3] U.S. Department of Commerce, Bureau of Labor Statistics recent data, *www.bls.gov*

[4] U.S. Department of Commerce, Economics and Statistics Administration, The Digital Economy 2002

Unfortunately, idle hands and lapsed tax moratoria are apt to become the devil's work. If H.R. 49 is not enacted to extend the moratorium, some state lawmakers could seize the opportunity to generate tax revenues with new laws that appear on their face to remedy false disparities between online and offline commerce. These laws could be challenged in the courts, but that would be a lengthy, confusing, and unnecessary process. Recent legislative proposals, for instance, would have allowed a "tax first, simplify later" approach.

This approach does not pass Constitutional muster. Any attempt by the states to overturn the *Quill* decision and the Commerce Clause proscriptions against undue burdens on interstate commerce by means of an act of Congress requires a rebalancing of the new authority. No greater disaster could evolve in this debate than for a mandatory duty to collect sales tax to be imposed on out-of-state merchants before the states have simplified their sales and use tax provisions in a uniform manner. The current balance of power would be upset if states were allowed to require out-of-state merchants with no physical contacts in the state to collect sales tax in the state before the states simplify their tax systems and Congress and the Supreme Court deem the simplification sufficient to allow this authority.

States must simplify first, and then seek Congressional approval in order to obtain expanded taxing authority. In the interim, keep the tax field level for businesses that do not have nexus and, therefore, tax collection responsibilities.

A final note on fairness: States do have the ability to, and in fact do, tax remote commerce. This power to tax is called the use tax. Sales made in a state by a remote vendor trigger a use tax obligation on the purchaser, rather than an obligation on the remote vendor, to collect and remit a sales tax. Again, states have the authority to collect the use tax from its residents, although it is admittedly a difficult tax to widely enforce. In fact, use taxes are politically unpopular, technologically challenging to administer, and jurisdictionally messy to enforce. Not surprisingly, therefore, states rarely enforce their own mechanisms. This is less—not more—reason to shift the burden to online merchants.

The second key reason ITAA supports H.R. 49 is because it eliminates the opportunity for states to tax Internet access. Let me be clear what we are talking about in this case. We are talking about stopping states from taxing the right to access the information superhighway, not sales taxes on goods or services purchased via the Internet. I emphasize this distinction because too often insufficient attention is paid to these two different ways of "taxing the Internet."

Taxing Internet access is bad public policy for a variety of reasons:

- Although doing so effectively raises the costs for all income levels, it would inhibit Internet use by those least able to pay, thus hurting efforts to bring Digital Opportunity to all Americans, regardless of income.
- Internet access is what is referred to as an enhanced information service, built on top of existing telecommunications infrastructure, a key distinction long recognized by the Federal Communications Commission. Internet Service Providers and the consumers that use them already pay taxes for their use of telecommunications services. For the consumer, those taxes paid by their ISP are buried in the fees they pay the ISP. Taxing Internet access would force consumers to pay taxes twice—once for the basic telecommunications service and once for the enhanced information service.
- By taxing access and thereby raising the cost of Internet service, lawmakers risk suppressing demand for broadband and network-enabled innovations at the edge of the network. ITAA believes, and this view is widely shared in Congress and in the Administration, that every dollar invested in broadband use delivers a substantial contribution to the economy, expressed in terms of new capital spending, productivity gains, next generation products and services, new business models and employment. It would be ironic indeed if this Congress, which is rightly so focused on expanding broadband usage in our country, which lags well behind other countries such as Korea, would allow the creation of a double taxation system that would inhibit broadband adoption.

As it should be, the attention of most Americans today is on the War in Iraq and homeland defense. In the midst of these headline-grabbing events, we must not lose sight of the fact that the U.S. economy must be defended. Part of this strategy must involve the digital economy and the threats that it faces from multiple and conflicting taxes, excessive overhead burdens, jurisdictional bedlam, and discrimination. By passing the Internet Tax Nondiscrimination Act, Congress has the opportunity to nurture the nation's high tech future while preserving a level playing field for business competitors and tax fairness for consumers.

We urge you to do so. Thank you very much.

ABOUT ITAA

The Information Technology Association of America (ITAA) provides global public policy, business networking, and national leadership to promote the continued rapid growth of the IT industry. ITAA consists of over 400 corporate members throughout the U.S., and a global network of 49 countries' IT associations. The Association plays the leading role in issues of IT industry concern including information security, taxes and finance policy, digital intellectual property protection, telecommunications competition, workforce and education, immigration, online privacy and consumer protection, government IT procurement, human resources and e-commerce policy. ITAA members range from the smallest IT start-ups to industry leaders in the Internet, software, IT services, ASP, digital content, systems integration, telecommunications, and enterprise solution fields. For more information visit www.itaa.org.

Mr. CANNON. We'd like to move to a period of questions, and again, we'll be very careful about the clock.

If I might ask all three of you the same question to begin. We live in a fairly complex environment where any CEO, especially of a high-tech company, who is persecuted and troubled by many things today, has a complicated analysis for anything he does. But it seems to me that clarity on this issue would have a disproportionate effect on the robustness or the aggressiveness of high-tech communities. In other words, recognizing the Government is going to get out of the way of innovation on the Internet, at least in this particular, would seem to me to be a fairly substantial element in the decision making of most CEOs of the many, many high-tech companies we have in America.

Would the three of you respond to that, starting, Mr. Duncan, if you wouldn't mind, with you.

Mr. DUNCAN. Certainty, of course, always adds and improves the ability of one to make economic decisions. I think if we're talking—if we're talking specifically, though, however, about the potential for taxes on charges for Internet access, I think that the role that might play in the decision of a CEO in a high-tech firm is relatively modest. That's that the charge—the tax would be on the charge that goes to the consumer and that's paid by the consumer, and while it raises the overall cost of service, the impact on his decisions is relatively modest.

Mr. CANNON. Would it not—take both pieces of this, which is the access charge and also the nondiscrimination and nonduplicative charges. Don't you think that would have an effect on most CEOs as they're looking at how they're going to perform and the environment in which other companies are also performing?

Mr. DUNCAN. The nondiscrimination piece, I think, really would have two points to make. Most of the pieces and descriptions of what constitutes a discriminatory tax, again, are related to consumer taxes and the potential of products that might be purchased using e-commerce services. So I think the impact there is relatively modest, and as I tried to point out earlier, the confines and constraints imposed by the U.S. Constitution currently provide——

Mr. CANNON. Let me just go back to the—isn't one of the problems here that it's a little complex and most CEOs don't want to sit down and figure this whole thing out about the difference between the various elements here and giving them clarity—if you could answer that briefly, then we'll shift to the other two.

Mr. DUNCAN. It's a complex world. To the extent that things can be clarified, people make better decisions.

Mr. CANNON. Thank you. Mr. Miller, would you like to address that?

Mr. MILLER. I agree with you 100 percent, Mr. Chairman, that what CEOs are looking for is clarity and certainty. Let's put yourself in the shoes of an ISP CEO, small ISP. There are several thousand ISPs in this country. We think of only the big ones that we see advertised on television, but the reality is the ISP community is very diverse and many of them are very small companies. Obviously, having uncertainty about whether or not there are going to be Internet access charges makes their business model more difficult, so in their position, you're 100 percent right on the mark.

Mr. CANNON. And more difficult to fund.

Mr. MILLER. Absolutely, more difficult to fund. Similarly, with small businesses that are trying to decide whether to go to the Internet and sell products over the Internet, as long as they're concerned about multiple and discriminatory taxes being levied in various jurisdictions around the country, that makes a decision as to whether to invest in setting up an expensive website where they're trying to promote themselves on the web that much more difficult.

So I think Governor Gilmore said it well earlier. The one region of the world that's trying to tax both the Internet access and products on the Internet is Europe, and what we're finding in Europe is low adoption rates of the Internet and low rate of purchases over the Internet. So what we see is when you tax this both access and sales across the Internet, you discourage use of the Internet rather than encourage use of the Internet.

Mr. CANNON. Thank you. Governor?

Mr. GILMORE. I think Mr. Miller has put it exactly right, but I think that the foreseeability issue is significant. People who wish to create tax revenues are very creative people and they'll think about lots of different ways that they can do this and all the different localities and different States and localities are going to try to do different things and it's going to create kind of a mess, frankly, that will be a burden not only on consumers, but on the businesses that are trying to perform the kind of service. They could decide that they want to do e-mail message taxation. They could decide they could do bits and bytes taxation or webpage taxation, online information taxation, you know. And frankly, all this stuff has been proposed and nothing stands in between the creativity of the taxer and the poor consumer other than H.R. 49.

Mr. CANNON. I'll tell you what, it is my experience that a mess tends to stand in the way of any kind of investment, that the creativity of taxing agencies, I hope, is only exceeded by the creativity of the American people, and I would certainly like to see a clear path.

The Chair now yields 5 minutes to the gentleman from Massachusetts, Mr. Delahunt.

Mr. DELAHUNT. I thank the Chair for yielding.

If I was correct, Governor, you indicated that some of those States that had benefitted from the grandfather provision in terms of the application of access taxes had, in fact, repealed them. Did I hear you mention the State of Washington?

Mr. GILMORE. The information that I have is that Tacoma had been putting on some additional taxes and that the State of Washington reversed that through some State legislation.

Mr. DELAHUNT. Okay, and there were other States, I think, that you referenced in your opening remarks.

Mr. GILMORE. Texas and Connecticut, I believe.

Mr. DELAHUNT. And I think my memory is that the term you used is that the trend is in the other direction, in other words, repealing at the State level though existing access taxes to the Internet. And while I can appreciate your concern and that of Mr. Miller in terms of the efforts to impose access charges, I think the reality is that the evidence indicates otherwise according to your testimony. I mean, obviously, since the moratorium, there has not been any additional effort to impose access charges to the Internet.

Are there any States, and I understand that they have their fiscal concerns right now, and maybe, Mr. Duncan, you can answer this question—are there any States that you're aware of that have under consideration, in the event that this moratorium should expire, would impose access taxes on the Internet? Mr. Duncan?

Mr. DUNCAN. I'm not aware of any that would contemplate doing so in the absence of the moratorium, but then, I wouldn't have perfect knowledge about that, either. I'm not aware that there are. You're correct. There have been—Connecticut is one State that repealed its tax on access charges.

Mr. DELAHUNT. Mr. Miller, you look like you want to respond.

Mr. MILLER. Mr. Delahunt, my hypothesis is that that was then and this is now, by which I mean 3 years ago when a lot of these repeal decisions were made, States and localities were relatively flush because of the strong State economy. As we know today, unfortunately, 45 out of 50 States, I believe, are running deficits, some of them huge deficits, and so tax commissioners and legislators, as Governor Gilmore and Secretary Kemp indicated, are trying to be very creative, and I understand that. They have to figure out new sources of revenue.

Again, we have the situation in Tennessee that we're involved in with this amicus brief where this issue has been debated over and over again——

Mr. DELAHUNT. But that's on the definition issue, is that correct?

Mr. MILLER. But Tennessee was one of the States exempted. They kind of quieted down for a couple of years, but now, because they're facing a State fiscal crisis, they're back revisiting the issue again. And again, it's not that I don't understand the pressures these States face, but the reality——

Mr. DELAHUNT. Can sympathize with them, obviously.

Mr. MILLER. Obviously, it's a problem that they're having. But to turn to the Internet access and make Tennessee as one of those States that would suddenly have Internet access charges, I think is unfair to the consumers in Tennessee.

Mr. DELAHUNT. Governor Gilmore, there are a number of governors that don't share your particular position on this issue. That's a fair statement.

Mr. GILMORE. Yes. Many have been defeated. [Laughter.]

Mr. DELAHUNT. Which ones have been defeated, Governor? Were they Republican or Democratic governors that were defeated?

Mr. GILMORE. Oh, no, bad tax policy extends to both parties, I can assure you. [Laughter.]

Mr. DELAHUNT. I'll accept that.

Mr. GILMORE. You know, I guess my kind of—if I can add anything to the discussion, Mr. Delahunt, it would be that if there's a sense that the trend, in fact, is against this kind of taxation, and the moratorium has been fairly uncontroversial, then there's just no harm in going on and making it permanent. It looks like we're all agreeing here.

Mr. DELAHUNT. Well I——

Mr. GILMORE. And the grandfather, too. There's no reason why people should clutch to these grandfather clauses if, in fact, the trend is away from it.

Mr. DELAHUNT. I think that's a valid observation. At the same time, really, I think what we're talking about here is that there are many at the State and local level that feel that there is a clear nexus, if there isn't pressure in terms of resolving the sales tax issue—that's really what we're walking around here—that nothing is going to happen.

Let me put it right out there, and let me start with Mr. Duncan and I'd welcome comments from Governor Gilmore and Mr. Miller. What's the progress of the, let me use the acronym, the streamlining project, the SSTP, and what can we look forward to in terms of resolution?

Mr. DUNCAN. First, just one word on the access charge. The issue is really the right of State elected officials and legislators to choose—legislators and governors to choose whether they want to impose the tax on services and whether it's consistent with their policy and it's not just a matter of which way the tide is going.

With respect to the streamlined project and the simplification, what we had, the point where we are is this, that in November of last year, delegates from some 30 States adopted the provisions of an interstate sales and use tax agreement that provides for some substantial simplification in the manner in which current sales and use taxes are administered and collected by the retailers. There are provisions about uniform definitions, provisions about safe harbors for retailers, provisions imposing the obligation on States to provide information to those retailers.

We're now in the process where the implementation of that agreement and the detailed changes necessary in State laws are being deliberated in State legislatures. To this point, there have been six States that have adopted all, or, I would argue, substantially all of the provisions that are necessary to implement that agreement. Consideration is being given in probably at least a dozen others. We would expect by the end of the summer to meet a threshold that is contained in that agreement of having at least ten States that have passed it and that those ten States would represent 20 percent of the population of those States with a sales tax.

So I think it's really been remarkable progress in terms of getting the detailed law changes necessary at the State level to really simplify administration of the sales tax.

Mr. MILLER. I would agree, Mr. Delahunt. I think that it's making very strong progress, and recently, Chairman Cox's State, California, announced that it was going to join as an observer in this

project for the first time, and obviously, given how large California is and what a large part of the economy, that's a major step forward.

Again, ITAA is not arguing, and the Chairman already said he is going to have a separate hearing on sales tax later on, so I'm not trying to preempt that hearing, but ITAA is not saying that Internet tax should get—Internet products should get favorable treatment as opposed to something you order through a 1–800 number or something you send in something from a mail order catalog. All we're saying and all the legislation is saying is you can't have multiple or discriminatory taxes.

So if this project moves forward to a successful conclusion and deals with the constitutional issues that were raised in the *Quill* decision and previous decisions, ITAA has no objection to that solution. But again, this legislation that Mr. Cox has narrowly crafted to deal with the issue of Internet access charges and multiple and discriminatory taxes, we believe is a separate issue, and as Governor Gilmore said, this Congress could pass that legislation without impacting one way or another the progress made by the State simplification effort.

Mr. CANNON. Did you want to address that, Mr. Gilmore?

Mr. GILMORE. I concur with Mr. Miller. There will obviously be a debate on this subject if they're ever able to get together any kind of critical mass of any kind. It's interesting that sort of the bar they've raised is that if 20 percent of the sales tax States could impose a regime even on those who don't have a sales tax, well, it's just kind of strange, but that's going to be later. That's the sales tax debate that's going to be so interesting later on in the year, which I will try to avoid if I can.

But that's not what we're talking about today. The issue today is a very simple one, and that is a very uncontroversial issue about not allowing the access to this by people and citizens all across the United States to be burdened, and this is the easy part, so we should move ahead.

Mr. CANNON. Thank you, Governor.

Mr. Carter, do you seek time?

Mr. CARTER. Thank you, Mr. Chairman.

Mr. CANNON. The gentleman is recognized for 5 minutes.

Mr. CARTER. Thank you.

Mr. CANNON. Would the gentleman suspend for just a moment? We wanted to acknowledge the presence of Mr. Watt, appreciate his being here. Thank you.

Mr. Carter?

Mr. CARTER. When you're back home in town hall meetings, you have people raise—the bricks-and-mortar people raise the issue that we're creating a tax-free haven by the Internet. Could I get comment from all three of you about that? Do you feel that's a valid complaint?

Mr. MILLER. Mr. Carter, it's not accurate. I can understand the frustration of some small business people, but that is not accurate. Again, for over three decades, this issue has been treated through the courts and put in a major decision in 1992 which Mr. Gilmore referenced in his statement, the so-called *Gilmore* decision—I mean, the so-called *Quill* decision—v. *North Dakota*. And it's not

because of the Internet, it's because of remote sales, and remote sales started back in the 19th century in this country. It's nothing that started suddenly in 1995 when the Internet came along. In fact, as much as Internet sales have grown, it is still much smaller than sales catalogs and 1–800 numbers. Yes, it's continuing to grow, but it's still much smaller than that.

Certainly, for certain purchases individuals make on the Internet, you do pay taxes. For example, if you order an airline ticket over the Internet, which is a Federal standardized set of rules for taxes, you pay the Federal tax on that ticket, just as if you walked into a ticket agent or just as if you bought it from your travel agency or just as if you bought it at the airport.

So all that the Cox legislation is saying is, no discriminatory taxes. If, as Mr. Delahunt's questions were suggesting, the States were able to solve the Supreme Court decision on the *Quill* decision, then the Internet goods and services sold over the Internet by remote sellers, just like 1–800 numbers, just like mail order catalogs, will be taxed. But the Internet didn't create this. This was created by a clear constitutional decision by the Supreme Court that unless there were a simplified taxing system so that you didn't have 7,500 different jurisdictions—which is what we have now—with their own set of rules and regulations, that was unfair to small businesses, that was unfair to people trying to sell to customers out of State.

And so the States have been on notice for a long time that they need to solve this problem. As Mr. Duncan said, and I agree, I think they're making some progress now, but it should not be attributed to the Internet in any way, shape, or form.

Mr. CARTER. Would anyone else like to comment?

Mr. GILMORE. Well, I think that's right, Congressman. We don't really ask bricks-and-mortar retailers to inquire of the person standing at their cash register what State they're from and then try to look up in some book someplace and apply some tax, and then send it up to the main office and send it in. We don't do that, so I think this is a reasonable way to approach it.

But today, once again, this is really just about sort of a different issue, and that's the question of whether or not we're going to impose taxes on coming through the door. We don't impose taxes on people going through the door of stores, either, and that's really what—all we're really talking about here today.

Mr. DUNCAN. I think the perception of the people back home and those people that are main street retailers is very easy to understand. I mean, they're in the business of trying to sell goods to people and people that sell remotely are trying to sell the same goods to those same people. One has a tax collection obligation. The other doesn't have the tax collection obligation for reasons that the Court put forth and that you've heard.

I think the message when the States have come and said, we ought to remove that differential, is that we're not going to remove it until the States simplify their tax collection. We've heard the message. We've understood it. We spent 3 years now, 2 years-plus, working with the retail community to understand where the complexities are and what ought to be done to simplify it, and I think

we're coming close to the time where we can put a plan of action into place and actually have a simplified agreement.

I agree with the Governor and Mr. Miller. This debate is not about that particular issue, but we will be back here with an up-and-running simplified system that will say, you told us to go simplify. Here it is and here it works.

Mr. CARTER. But that's addressing the sales tax issues we're talking about.

Mr. DUNCAN. That's right.

Mr. MILLER. Also, Mr. Carter, if I could make one more observation—again, I don't want to preempt the Chairman's future hearing on the sales tax, but I do believe Texas is one of the many States that does have a use tax. And, in fact, there was a story last year, if I remember, some State official was caught out because he had not paid a use tax on a fairly substantial purchase he had made. I don't think he bought it over the Internet, I think he bought it through another means of remote seller.

So at least theoretically, every consumer who buys things in most States of the Union, including Virginia, where I live and Governor Gilmore's State, theoretically, the consumers, if they don't pay a sales tax, are supposed to pay a use tax. Now, the reality is that most States don't educate consumers about this. They don't go out and actively promote it, and, of course, consumers don't even know about it, or if they do, they don't pay attention to it when they file their State income taxes.

But the reality is, it is supposed to be a level playing field to that extent. The Supreme Court did not outlaw use taxes for products bought remotely because the theory was the consumer knows what the State sales tax is and should be able to pay it. What they outlawed in the *Quill* decision, they said was unconstitutional, was requiring some small business person in a remote State who doesn't have any physical location in the State where the consumer lives to figure out what the State tax rate is or local tax rate is.

Mr. CARTER. Thank you. Mr. Chairman, I'll ask unanimous consent to extend my time for 5 minutes so that I can yield to Mr. Cox.

Mr. CANNON. Without objection, so ordered.

Mr. CARTER. I yield my time to Mr. Cox.

Mr. COX. Thank you, Mr. Carter. Thank you, Mr. Chairman. I want to again thank our panel for being here today, in particular for your focus on what I think is a general area of agreement. Governor Gilmore, Mr. Kemp, Mr. Duncan, and Mr. Miller all told us that, representing your own positions or the groups for whom you were speaking, there is no proponent on this panel for multiple and discriminatory taxation for the Internet. I'd give anybody a chance to correct that record if I've mistakenly stated it, but that's my understanding, that there is no proponent of multiple and discriminatory tax on the Internet now or in the future.

Mr. MILLER. That is correct.

Mr. COX. And that being the case, I think we have essentially licked 90 percent of this battle. I think that there are significant differences, certainly between Mr. Duncan, the organization that you represent, and others on this panel, concerning the ultimate policy choice of how you would tax sales on the Internet and the degree to which Congress has a role in this. I know, Mr. Duncan,

that your view is that Congress, or rather more specifically, your group's view, the Federation of Tax Administrators' view is that Congress should not pass any statute that in any way, whether we're exercising our interstate commerce authority or not, that in any way interferes with any State's ability to collect any tax. That is how I read Resolution 18 that you've adopted, is that correct?

Mr. DUNCAN. That's correct. Our general proposition is that the Constitution provides the confines and constraints on State and local taxation and that absent some compelling showing that that's not working, that Congress should refrain.

Mr. COX. Now, you don't suggest that there's anything unconstitutional about the Internet Tax Freedom Act or the Internet Nondiscrimination Act? You wouldn't challenge its constitutionality, would you?

Mr. DUNCAN. I'm not challenging it, no.

Mr. COX. Okay. That's—so the real question for Congress is where should we exercise our interstate commerce authority, and the reason that we chose to do so here is not so much the fledgling industry argument, but rather two things. First, the pervasiveness of the Internet and the degree to which it enables so many different things in so many different ways throughout both the commercial and non-commercial sectors of our economy. It is the most essential of essential infrastructures in the information age.

And second, the degree to which its unique packet-switched architecture subjects it to multiple taxation in ways that we haven't seen with any other goods or services subject to similar tax regimes.

So we had, prior to the enactment of this legislation, we had at least some tax administrators, some witnesses from various States claiming that they were going to tax transactions where neither the buyer nor the seller was in their State, but the transaction was routed through a server located in their State. These are unique questions, and it's for these reasons that Congress decided to occupy this field.

That leaves us, then, with this question of Internet access taxes and particularly the grandfather that you raised, Mr. Duncan. My latest information is as follows, that the States that currently tax Internet access are North Dakota, South Dakota, Tennessee, Wisconsin, Ohio, and Texas, and, in fact, that CRS—I have conflicting reports on this. As of March 2003, CRS tells us that Connecticut has no such tax, Iowa has no such tax, even though they did back in 1998, that South Carolina has no such tax, that the District of Columbia has no such tax. They've all gotten rid of theirs since 1998.

Let's see. The last information I have is that AOL, the largest ISP in the country, does not collect taxes in any State, suggesting that no tax is imposed lawfully on Internet access anywhere in the United States of America, the reason being that the original law stated that a tax, in order to be grandfathered, had to be generally enforced and actually imposed prior to 1998, and, of course, none of these States has a statute on the books that taxes Internet access. What they've done is they've gone back and reinterpreted old telecommunications tax laws or something to apply in the future to

Internet taxation, and they weren't doing this prior to 1998, prior to the enactment of the law.

So, in essence, we have no States in America that have lawfully imposed an Internet access tax since the enactment of this moratorium. That's my understanding. I don't know if anybody wants to comment on that, and I think I've run out of time, but I would yield to Mr. Coble if I have any time left.

Mr. MILLER. My only comment would be, Mr. Chairman, we agree with you, that there was no legislation passed. It was creative tax administrators coming up, and as I said, we're fighting this battle in Tennessee.

The second point, again, I think the Subcommittee is very aware of it, but it's probably just worth restating. People who access the Internet do pay taxes, Federal, State, and local, because they use telecommunications services. The Internet rides on telecommunications services. Access to the Internet for most people is through telecommunications services and that does generate revenue for the Federal Government, the State government, and local governments.

So the idea that somehow there is no taxation involved in getting access to the Internet is simply untrue. And, in fact, one of the items which is driving telecommunications use in this country is, in fact, use of the Internet. We're now having, of course, wireless is growing dramatically. The wireless providers are trying to provide through their wireless devices Internet access. Well, the more you use wireless, again, every tax bill you get from your wireless provider has taxes on it.

So the idea that there's no correlation between this expansion of the use of the Internet and revenue is simply false. It's just that you cannot, under your legislation, independently have double taxation by taxing Internet access and telecommunications.

Mr. COX. In fact, the national average of telecommunications access taxes is 18 percent of retail.

Mr. DUNCAN. I just have to take exception to the statement that there's no lawfully imposed tax on charges for Internet access. I think the list of States that you had, we would agree with. We would add two others. Washington taxes gross receipts of the Internet service providers under its business and occupation tax, and New Hampshire imposes a communications services tax that picks up some providers of Internet access.

The States that impose the sales and use tax, including Wisconsin, Tennessee, North Dakota, South Dakota, New Mexico, have done so under their statutes that either, in one of three ways: it was considered part of telecommunications, it was considered an information service that had been made subject to the tax, or you have situations such as in Tennessee—I mean, excuse me, New Mexico and South Dakota where all transactions are subject to tax regardless of whether they're a sale of a good or service unless they're specifically exempted. Those States, to my understanding, do impose the tax on charges for Internet access. They did so in 1998. It was known to the providers, and they continued to collect them.

Mr. CANNON. Thank you. Ms. Baldwin?

Ms. BALDWIN. Thank you, Mr. Chairman. I want to express my appreciation to the witnesses for sharing their time and expertise.

I wanted to pursue two lines of inquiry in our brief time. As you know, Wisconsin is one of the States that is grandfathered under current law and the State taxes Internet access as part of its 5 percent sales tax. It's my understanding that this tax is applied equally regardless of type of Internet service, cable, DSL, or dial-up.

Governor Gilmore, you and others have made arguments that the ban or moratorium on Internet access taxes has encouraged growth in people's access to the Internet and, conversely, that such taxes constitute a barrier to access, and I'm hoping that you might be able to provide me with some quantifiable evidence to support that contention, and I ask because the evidence that I've seen as it relates to my home State of Wisconsin does not support that conclusion.

Let me share with you today that in 1998, when the moratorium was first imposed, according to the U.S. Department of Commerce data, 26.2 percent of American households had Internet access, and in that same year, Wisconsin had roughly 25.1 percent access, which is within the survey's margin of error. By 2001, access had grown to 50.5 percent of American households, and in Wisconsin, 50.2 percent of Wisconsin households had Internet access.

And we don't just have to confine our examination to Wisconsin. Some of the other States, North Dakota was below the national average in 1998 despite their access tax. They reached the national average by 2001. Tennessee was 5 percent below national average in 1998 and has risen to 3 percent below in 2001. And so I'm hoping you'll be able to address that.

I want to quickly leap to my second line of inquiry and then let you respond. The other point I wanted to make was also raised by Mr. Duncan in his testimony and it goes to that definition of Internet access. The definition includes the clause, and I quote, "access to proprietary content information and other services as part of a package of services offered to users," and I'm concerned that this very broad definition will allow a telecommunications company to engage in an inappropriate type of bundling of services with the sole purpose of evading appropriate tax under the law.

I don't know if this is a plausible example or not, but we'll ask you that question. I'll give you an example of what I think would be plausible.

Suppose an Internet provider put together a law firm Internet service package. The Internet provider as part of the package includes their proprietary content that's the equivalent of LEXIS/NEXIS, their own search engine on the U.S. Code, and other content that would be quite expensive if purchased separately. It seems to me that bundling these things tax-free would be permitted by this definition, and Mr. Duncan, I wonder if you foresee this type of problem or if you have any—and/or if you have any suggestion for our Committee in tightening up this definition.

I don't know if you want to take it in order, Governor Gilmore?

Mr. GILMORE. Congresswoman Baldwin, we'll just have to take a look at the good work you've done with respect to your statistics and information and just take a look at that and make it available. We really don't know, do we, I guess, what the difference is between Wisconsin and, say, Texas or Virginia or Florida. I think we're really trying to look at people out there who are of very lim-

ited means, in distressed situations, and we probably ought to look at that category of people in Wisconsin and see how it has affected them, and the same in Florida and the same in Virginia for a national policy.

It may be that Wisconsin is of a demographic position to continue to grow their access because of the favorable economic situation of the individual citizens of Wisconsin. It would not replicate itself in States with disadvantaged populations. That's something, I think, that's reasonable to look at.

Mr. MILLER. I would just add, Ms. Baldwin, that 94 percent of American households have access to telephones, but only 50 percent have access to the Internet. We want to get to 94 percent, and I would echo the point that Governor Gilmore made. If adding the cost is discouraging people of modest means from gaining access to the Internet, and various research has shown that, in fact, cost is a major factor in the decision of whether or not to get Internet access, it seems to me Congress wants to be discouraging, making it more expensive by adding in access charges. The first 50 percent is the easy part, in a sense, upper income and middle income. When we get to people of lower socio-economic status, we want to make that as inexpensive as possible.

Ms. BALDWIN. Mr. Duncan?

Mr. DUNCAN. Just a word here. We've heard several times today that there's no desire to provide special treatment to the Internet, but a Federal law that prohibits taxes on Internet access is exactly that. It is special treatment for the Internet. One could list another host of transactions in goods and services that ought to be available to all households and reach the 94 percent level, but those probably have tax on them. The question is, are you going to prevent taxes on those at the same time you would Internet access?

But let me—your bundling question, I think, is exactly on target, and that's one of the points that we've tried to raise, is that the definition that was devised in 1998 worked then for what we knew about Internet access at the time. It's been five very rapidly changing years in that business and we think that the 1998 definition deserves to be revisited, and one of the key issues is exactly this.

It would be hard to think about a service that couldn't be bundled in with access and fit within the definition that's currently in the law, whether that's a data service, a voice service, or a video service, and the idea that one could put together, you know, lawyers.net and package access and that package of services, sell it to that particular clientele and call it all access and say we can't unbundle it, I think is a very real concern, and that has two issues to it. One, it erodes the base of a State that might tax information services, and the second is, it discriminates against those that are trying to sell those very same content services but not bundling with the access, and that's why we'd argue that you ought to look at the definition.

We have wrapped ourselves around the axle several times trying to devise a definition. One approach that we have considered and would suggest that's worth consideration is the Texas approach, which says if it's Internet access, the first, I believe the current law is $25, is exempt, basically saying this is some core level of access that we're willing—that that would be exempt in Texas. But if you

get above that, then you must be bundling content. We tax information services, and that part above $25 is considered taxable unless there's a demonstration that it's somehow not a taxable information service.

That has some merit that we would suggest that you look at. There are probably other approaches and some other issues beyond the content bundling that need to be examined, as well.

Mr. CANNON. The time of the gentlelady has expired, but Mr. Miller, would you like to briefly address that, since he addressed the question to all three of you?

Mr. MILLER. Again, we have today bundled services available through many Internet service providers. I think that Ms. Baldwin's case is an interesting one, but it's a business-to-business situation. I don't think any of these are consumers who are interested in lawyers.com or LEXIS/NEXIS access. That's something normally that a business or a law firm would be interested in.

What we're talking about is average consumers and the kind of services that are provided or put together in very simple packages, and if that encourages more people to use the Internet, that's something, again, we should be trying to encourage, particularly for the have-nots, the other 50 percent of the population who have not yet chosen to get on the Internet, which is what we in the IT community are really interested in.

I've already got all the Internet access at my house. I've got one, my wife's got one, both kids. The dogs don't get any. We're worried about the other 50 percent of the population and that's where our future growth is, Mr. Chairman, and we want to make sure that that's as easy and affordable as possible for consumers so we get up to the telephone level penetration of our country.

Mr. CANNON. Thank you, Mr. Miller.

Does the gentleman from North Carolina seek recognition?

Mr. WATT. Thank you, Mr. Chairman.

Mr. CANNON. The gentleman is recognized for 5 minutes.

Mr. WATT. I appreciate the gentleman recognizing me. I won't take 5 minutes unless Ms. Baldwin needs some of my time. I just wanted to thank the witnesses for being here, thank Mr. Delahunt for substituting for me and being the Ranking Member today. He looks pretty distinguished in that Ranking Member chair, I think. [Laughter.]

Mr. CANNON. With all due respect, not as good as you look. [Laughter.]

Mr. WATT. Well, I don't want him to get too comfortable. I needed an Internet provider this morning to do my heating and air conditioning services at my house. There's nothing more frustrating. And I would have been prepared to pay tax on it, if I could have found such. There's nothing more frustrating than waiting on people, service providers to come to your house, and you can't leave.

Let me just make a couple comments, one comment about your access issue, Mr. Miller. In most of the States I'm aware of, telephone access is taxed in some way or another, so to compare this to telephone usage really doesn't seem to me to be that great an analogy. People, if they want access, will pay the tax. If they don't want it, they won't pay the tax, and I think that's pretty much the case.

It was not clear to me whether Mr. Gilmore or Mr. Miller ever responded to whether they thought there was a need to revisit this definitional issue that Ms. Baldwin raised. Do you think there is a problem with the definition or do you not, and if so, do you have some ideas about how we might tighten up that definition so that we don't run into the problem?

I disagree with Mr. Miller that it's not individual users that access LEXIS/NEXIS. Businesses do access it. Lawyers, law firms access it. But a bunch of lawyers I know and non-lawyers who try to do their own research access it, too.

So do you think this definition needs to be tightened up or not, and if so, do you have any ideas about how to do it?

Mr. MILLER. Let me respond to the first point and then I'll let Governor Gilmore address the second point, since his Commission did discuss at length the bundling issue during its commission.

The reason I brought up the telephone service, Mr. Watt, is the Congress has established something called the Universal Service Fund, as you know, which we all pay into, in order to subsidize telephone access in this country. The Internet community is not asking for that. We're just asking not to put additional charges on access to the Internet. That's what the Internet access prohibition in the Cox bill is all about.

Mr. WATT. That seems to me to be a separate issue than the one I raised. I mean, whether you want a universal service fund or not——

Mr. MILLER. I don't.

Mr. WATT [continuing]. Is not the issue, it seems to me. The issue is if you're going to compare Internet access to phone access and phones have—phone customers, 94 percent of them are using the telephones and they are being taxed on it in most locations, independent of the Universal Access Fund, they're being taxed on it, it just doesn't seem to me that that's an appropriate analogy.

But that's not the heart of my point. I just was making that point as an observation.

Mr. MILLER. Right.

Mr. WATT. The real point is, is there a definitional problem here, and if there is, how do we solve it?

Mr. MILLER. We don't believe there is a definitional problem, and Governor Gilmore's Commission on Electronic Commerce spent a lot of time discussing this issue——

Mr. WATT. Mr. Gilmore?

Mr. GILMORE. Congressman, we think the definition is okay. I suppose that if you wanted at some future time to consider broadening this definition to include telecommunications taxes, as well, you could do that. I don't think that you have to do that now in order to enact this legislation.

Mr. WATT. So you're opposed to tightening the definition in this bill——

Mr. GILMORE. Oh, no, the——

Mr. WATT [continuing]. To make sure that it's limited to access rather than content?

Mr. GILMORE. You know, I think that we have mediums all the time that deliver content over the telephone and radio and so on. We don't tax individual television shows and so on like that. And

you want content, it seems to me, to be available to the most people that you possibly can.

I think this definition is okay the way it is, but you could revisit it at a future time and address the issue, for example, that poor families in the City of Richmond have to have a telephone and, therefore, they're sort of forced to pay a 25 percent telephone tax and the potential injustice of that, but I don't——

Mr. WATT. Of course, the flip side of that is you may be arguing for a Universal Access Fund for—like Mr. Miller said he opposed for Internet access, too. I'm not advocating that, don't get me wrong, just, you know, what cuts, cuts both ways, it seems to me.

Mr. GILMORE. It's a real problem with this whole issue. But I think you could go forward with this definition, Mr. Watts.

Mr. WATT. Thank you, Mr. Chairman. I apologize to the Chairman for being tardy.

Mr. CANNON. You're fine. I think the game here is to ask the questions and let them go way over time on the other side, which actually works out pretty well.

Let me just poll the panel. Is there an interest in a second round? One of the problems is just timing, but there's a number of people who handed me questions. Congressman Coble asked me to ask a question. He had a meeting that he had to run to. So I'll ask unanimous consent that I may take an additional 5 minutes, but not open it up to a second round. Thank you. So ordered.

Let me ask Mr. Coble's question first. His concern is with the use tax and the difficulty in enforcing it, because, first of all, people either don't know that it's there, that that indicates, I think in the case of Utah, that people don't read their tax returns before they sign it, because it's part of the return, or if they know it's there, they know that it's almost impossible to enforce.

So Mr. Coble's question would be, isn't it difficult to use the alternative to a sales tax on the Internet through the use tax just because it's hard to apply, and I think, Mr. Duncan, if you wouldn't mind answering that, and then, Governor Gilmore, with your experience, and perhaps if you have some comments, Mr. Miller.

Mr. DUNCAN. Collection of use tax on any sort of remote transaction from the individual purchaser and consumer is difficult. It is not cost efficient for States to try to enforce that. It is—there's a burden on the individual of keeping records of what they've purchased and then accruing and reporting that. So for that reason, the inability to effectively deal with it, you know, from the individual purchaser on their individual items, that we've argued that it ought to be collected by the seller in the same fashion as the sales tax. That's where the simplification comes in and the requirement for a Congressional authorization so that States could require remote sellers to collect, and that's the next debate in the next hearing.

Mr. CANNON. I know I've asked all the panelists to respond to that, but can I just add another layer to this. Given what you've just said, doesn't it make sense for the States, and especially those groups, the States that are working on the SSTP, to encourage their legislators to eliminate the use tax for Internet as sort of a show of good faith as they move down the SSTP path?

In other words, you can't get the tax, it makes liars out of all of us except me. I mean, I don't buy anything in Utah. I don't know about my kids. I try not to use anything they buy. I don't use their tennis shoes, their cleats, for instance. The fact is, I buy my stuff on the Internet, usually books here in Washington, D.C., because there's no tax, and so I don't have to—I'm not lying when I sign that saying I'm not doing any use, but that's an awkward thing that is unique probably in my case.

Shouldn't the States—let me just leave it to you, shouldn't we take a look at those in the State legislatures and then try and address this later on in the SSTP?

Mr. DUNCAN. I think we have to separate the imposition of the tax, which is the use tax that's owed by that consumer, and the collection responsibility. We wouldn't want to repeal the imposition of the use tax on the individual purchaser. What we've got to do, in our estimation, to make sure there's a level playing field between those that have to collect the tax and the remote sellers that now don't have to collect the tax, is to simplify it and to have then the authorization extended through remote sellers. We're finding that, you know, as we simplify, there are some remote sellers coming forward voluntarily.

Mr. CANNON. But I don't think you're going to the question that I've asked, which is doesn't it make sense for States to—if you want to simplify it, to start out simplifying with a good faith effort of getting rid of a tax that's imposed based upon the good faith of the recollection of the taxpayer, which is the use tax for items purchased on the Internet.

Mr. DUNCAN. Apparently, I'm not quite understanding the question. I mean, the States at the present time are engaged in an effort—I mean, they try to simplify it for individuals, as well, through increased use of the income tax and that sort of thing.

Mr. CANNON. I'm sort of skipping away from the SSTP, and I'm just irritated in my State legislature because they impose a tax on me, as do many other States, that require me when I fill out my tax return to sign a statement saying that I swear I'm not using anything in the State that was purchased outside the State without paying a sales tax. Doesn't it make sense not—this is not God ordaining, but shouldn't the governors who are pushing the SSTP step forward and say, hey, we're not making anything on this use tax. Why don't we not make our citizens liars and get rid of it and solve the problem with the SSTP?

Mr. MILLER. It seems to me——

Mr. DUNCAN. I guess that's what we're trying to do, is to get ourselves in a position so that individual doesn't have to do that because it'll be collected at the time of purchase.

Mr. CANNON. I want to talk to my legislators about that in the context of your response. [Laughter.]

Mr. MILLER. This is a personal opinion, not an ITAA position, Mr. Chairman, but I think you go right to the heart of the matter. The sales tax itself was created at a time when people were not very mobile in terms of their purchases and in which time Government didn't know very much about how much people earned, but they knew a lot about how they spent in terms of taxing the merchants, and they made the merchants the State tax collectors.

So the question is, why in 2003, when we live in an incredibly mobile society, when people make purchases not just all over the country but all over the world, in which the Government has almost perfect knowledge about how much each of us earns, why are we still making small businesses the tax collector for the State?

Again, that's your next hearing on sales taxes. But I think your comment goes right to the fundamental position that we have a tax system in 2003 designed for the 1930's.

Mr. CANNON. Governor Gilmore?

Mr. GILMORE. Use tax doesn't bring much in, as a practical matter. That was our experience. If we'd make it more consistent across the board, then it probably should be eliminated. But simplification alone is no excuse for taking the policy position that we're going to impose new taxes on a new medium, or multiple and discriminatory taxes, or confused sort of regimes like we've seen with telephone. This is an opportunity here, it seems to me, to step forward and settle the easy part and then fight over the hard part later on this year.

Mr. CANNON. Thank you, Governor.

I ask unanimous consent to extend my time by 3 minutes. So ordered.

Let me turn some time over to yield to Mr. Delahunt in a moment. Let me just point out that the SSTP, the streamlined sales tax, is a very important issue and it's an issue that we need to deal with. I think that we have an absolute consensus, if I can take from your comments, Mr. Duncan, is we have a consensus that's an important issue and that we have some things in there that are awkward and to solve that is going to take some national effort and some focus.

I've committed to a hearing on that issue, but I would encourage the people of America to understand that this is a separate issue from the tax moratorium. We need to solve this and then start taking some steps toward much more rational taxation.

I might just point out that the SSTP is not the only place we can rationalize our tax system in America. We can certainly rationalize our Federal system, as well. So we have a number of issues before us. I would encourage the panel and the Members of the Committee to recognize that difference and support a permanent moratorium, and with that, I yield to Mr. Delahunt for a question.

Mr. DELAHUNT. Before I pose a question to the panel, I just want to ask a question of the Chair. When he states that he buys nothing in Utah——

Mr. CANNON. On the Internet.

Mr. DELAHUNT. On the Internet, okay.

Mr. CANNON. Literally, I actually work very hard to not buy anything on the Internet in Utah, because when I sign that tax return, I don't want to be a liar.

Mr. DELAHUNT. Okay.

Mr. CANNON. And it's a damn inconvenience, if you'll pardon the expression here, and Americans ought to be irritated about it. To the degree they don't know about it, they ought to understand and ought to demand a change in that law.

Mr. DELAHUNT. I think you have obviously focused on the nub. I mean, clearly, as Governor Gilmore just indicated, I think we all

recognize compliance with the use tax is just—it's not feasible for a variety of different reasons.

But before we conclude the hearing today, Mr. Duncan, in terms of the progress being made on SSTP, and I know this is maybe a question that cannot be answered with any precision, but just an outside, remote estimate, if you will, at what—how far are we in terms of achieving a critical mass that would create the—in which a potential interstate compact would be presented to Congress for its consideration?

Mr. DUNCAN. In the agreement that was adopted by the States, the threshold put in there to activate the agreement was ten States with 20 percent of the population. We believe that that'll be met this year during legislative sessions, and it really comes down to meeting that threshold, the handful of getting two or three States like Texas, New Jersey, North Carolina finishing up some work, to Michigan, States of that size. Then, I think, as we go through the year, some of those larger States have longer legislative sessions, and as we see a movement in California, some in New York, I think the prospects then for that 1 percent becoming much larger.

Mr. DELAHUNT. Okay. But you use, in my opinion, a near future resolution, because I think it's important also to note that, you know, the National Governors Association, a variety of various business associations, trade associations—I'm looking at some of them here, real estate associations, shopping centers, the Newspaper Association of America, some members of the high-tech community, Gateway and Vertical Net, are concerned about coupling these issues, and I understand the Governor's position and your position, Mr. Miller.

But, you know, I dare say the fact that we have extended the moratorium for a discrete period of time as opposed to making it permanent does not in any way jeopardize the growth of the Internet, and I wonder if during the course of this particular session of Congress, the 108th, you'd be in a position to consider both the SSTP and making it a permanent moratorium, and if so, I'm sure the Chair and others would welcome the support, if after review by individual Members, for both of those particular proposals, because we can't deny the reality, and you may be very well correct, Mr. Miller, in terms of it's a 1930 answer, but, man, we have serious problems as far as these States are concerned.

I don't know what the aggregate number is, but we hear California with a $35 billion deficit. My governor, who is a part-time resident of Utah, Governor Romney, I am sure would be very upset with me, Mr. Chairman, if I should support a permanent moratorium, and he is a very good Republican, by the way——

Mr. CANNON. I would hope not, but also, as Mr. Gilmore would say, he's a governor.

Mr. DELAHUNT. He's a governor. But the reality is, I guess, Mr. Duncan, the message to you is to go back to those that are sitting down grappling with this particular issue and let them know that I would think, I would think that the fiscal pressures on the States now are conducive and would serve as an impetus toward the streamlining project to reach a conclusion, and I think the Congress obviously is willing to listen to an interstate compact dealing with the issue, and with that, I'll yield back and thank the Chair.

Mr. WATT. Mr. Chairman, could you yield to me just for a second?

Mr. CANNON. Certainly, Mr. Watt.

Mr. WATT. I don't think this is critical to the hearing, but just to clear up one thing that Mr. Miller and I had an exchange about, and that's about this e-rate. Staff has pointed out to me that the e-rate is actually used to encourage access to the Internet, not to encourage access to phone service. So just to make that clear for the record, I don't think there's any disagreement about that, but I wanted to be clear on that. It's not really a fund that encourages or subsidizes the use of phones. It's a fund that phone companies collect to subsidize and encourage the use of the Internet and that kind of technology.

I appreciate and yield back.

Mr. CANNON. The gentleman yields back.

First of all, I want to thank the panel for being here today. We appreciate your time.

I'd like to ask unanimous consent to submit questions to the witnesses to be included in the record. Hearing no objection, so ordered.

Mr. CANNON. The record will be kept open for another 5 days for any submission of comments that you want to make or answers to questions.

Again, thank you very much for your time. I think this has been a very enlightening hearing and the meeting is now adjourned.

[Whereupon, at 11:48 a.m., the Subcommittee was adjourned.]

APPENDIX

MATERIAL SUBMITTED FOR THE HEARING RECORD

April 11, 2003

The Honorable James S. Gilmore, III
Kelley Drye
1200 19th Street, NW
Suite 500
Washington, DC 20036

Dear Mr. Gilmore:

Thank you for appearing before the Subcommittee on Commercial and Administrative Law on April 1, 2003. Your testimony, and the efforts you made to present it, are deeply appreciated and will help guide us in whatever action we take on the issue.

Attached is a copy of the official transcript of this hearing. We have provided this for your review. Please limit any corrections you make to technical, grammatical and typographical errors. This transcript is substantially a verbatim account of remarks actually made during the hearing. No substantive changes are permitted.

Pursuant to the unanimous consent request agreed upon at the hearing, Subcommittee Members were given the opportunity to submit written questions to the witnesses. Accordingly, I request that you respond to the following questions:

- What justifications exist for maintaining the current definition of "internet access" as provided in the Internet Tax Freedom Act? Please discuss the bundling issue as it relates to the definition of "internet access."

Your response to these questions will help inform subsequent legislative action on this important topic. Please submit your written responses to these questions by 5:00 p.m. on Friday, April 25, 2003, to: Diane K. Taylor, Subcommittee on Commercial and Administrative Law, B353 Rayburn HOB, Washington, D.C. 20515. Your responses may also be submitted by e-mail to diane.taylor@mail.house.gov. If you have any questions, feel free to contact Diane K. Taylor at

202.225.2825. Thank you for your continued assistance.

Sincerely,

CHRIS CANNON
Chairman
Subcommittee on Commercial and Administrative Law

cc: Lee Goodman

CC: dt

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April 25, 2003

The Honorable Chris Cannon
Chairman
Subcommittee on Commercial and Administrative Law
U.S. House of Representatives
2138 Rayburn House Office Building
Washington, DC 20515-6216

Re: H.R. 49 - Internet Nondiscrimination Act

Dear Chairman Cannon:

I am pleased to respond to the questions posed by your April 11, 2003 letter related to my testimony given before the Subcommittee's April 1 hearing on H.R. 49, which proposes to make permanent the Internet Tax Freedom Act (47 USC § 151) and amend that Act to preclude certain previously grandfathered state taxes on Internet access.

As you know, my testimony stressed the importance of enactment of a permanent and national prohibition against state and local taxes on Internet access to protect Internet access providers and the individual citizens who log on the Internet from the detrimental effects of a telephone-like tax system. The national economy, U.S. global competitiveness, and American culture depend vitally upon nurturing full development of the Internet. Such nurturing requires keeping taxes and regulatory burdens on Internet access to a minimum. Accordingly, I urged passage of H.R. 49.

In that context, your April 11 letter forwarded for my response the following question submitted by a Subcommittee Member in accordance with the applicable unanimous consent procedures:

> What justifications exist for maintaining the current definition of "internet access" as provided in the Internet Tax Freedom Act? Please discuss the bundling issue as it relates to the definition of "internet access."

As I will explain below, the overarching justification for maintaining the current definition of Internet access is that it is clear and unambiguous as well as adequately broad to provide tax and regulatory protection for most American Internet access services along with the software and content necessary to make the Internet a useful, practicably navigable, and safe communications medium. The current definition also encourages innovation and growth in Internet access services with minimal tax and regulatory barriers. Finally, the current definition is needed to protect Internet access providers and individual Internet users from new taxes that would be stimulated through enactment of a narrower definition.

Definition Of "Internet Access" In The ITFA

The current definition of Internet access, found in Section 1104(5) of the Internet Tax Freedom Act, provides as follows:

> **(5) Internet access.**--The term 'Internet access' means a service that enables users to access content, information, electronic mail, or other services offered over the Internet, and may also include access to proprietary content, information, and other services as part of a package of services offered to users. Such term does not include telecommunications services.

Thus, the current definition includes any service that enables users to access content, information, email or "other services" offered over the Internet. It makes explicit, perhaps redundantly, that Internet access may include access to "proprietary" content, information or other services as part of a package. This definition is very flexible and permits the types of service packages offered to consumers to vary greatly today and could encompass many other different types of services that may be conceived and/or made feasible tomorrow. In this way, the definition facilitates the evolution of Internet services in response to market forces as new technologies become available, without market distortions caused by the threat of new taxes and their attendant compliance and regulatory burdens.

The only express limit in the "Internet access" definition is that it excludes "telecommunications services." That exclusion reflected Congress' recognition that telecommunications services are and have been subject to heavy state/local taxation and that the purpose of the Internet Tax Freedom Act was to prevent the emergence of new taxes, rather than to roll back existing taxes. I have long felt that taxes on telecommunications services are excessive, and part of the justification for the Internet Tax Freedom Act was and remains to prevent Internet services from incurring similar excessive tax burdens.

A Common-Sense, Consumer-Based Understanding Of "Internet Access"

Critics of the Internet access definition contend that it is flawed in that it somehow encompasses more than access to a system of computer networks through a router. That position presumes that everyone agrees on some narrow definition of what constitutes the Internet, a position that is anything but clear. To illustrate, consider the definition of "Internet" used by the Internet Tax Freedom Act itself:

> **(4) Internet.**--The term 'Internet' means collectively the myriad of computer and telecommunications facilities, including equipment and operating software, which comprise the interconnected world-wide network of networks that employ the Transmission Control Protocol/Internet Protocol, or any predecessor or successor protocols to such protocol, to communicate information of all kinds by wire or radio.

Thus, Internet, as that term is used in the Act, means nothing more than equipment and operating software that employ some protocol to communicate information by wire or radio. But when consumers or business users think of the Internet, they do not have in mind obtaining access to equipment and software. Rather, they have in mind accessing some content or services that can be provided using equipment and software, and they expect those services and content to be made accessible by an Internet access provider.

Today there are many different types of services that are commonly provided to an individual Internet user. Some of these services provide tools for the Internet user, such as email, the ability to visit and use websites of government agencies or businesses, the ability to perform some economic task such as paying bills online, or a collection of news articles or links to news articles and stock quotes. Other services play a supporting role - for example, services that provide security or privacy to Internet users or services that help the user search for desired information or a desired service. Merely to illustrate, Microsoft describes its relatively new MSN 8 Dial-up Internet service as including 21 such service features, ranging from SPAM filtering software to online bill paying services (see http://www.join.msn.com). Earthlink's subscribers log on a home page that offers numerous news articles and stock quotes (see http://www.earthlink.com). America On-Line offers similar services (see http://www.aol.com).

Nowhere in the Act does language attempt to specify which current and future services define the Internet, and I would submit that Congress will find no consensus on which current services constitute "Internet access" and which do not. In my view, any of the services offered now (or in the future) can properly be viewed as part of the Internet to which users seek access.

The foregoing notwithstanding, it may be worth noting that there is one respect in which the Internet Tax Freedom Act expressly requires an Internet access provider to "bundle" services with router service. Under Section 1101(f), in order to remain free of state taxes, an Internet service provider must offer "screening software that is designed to permit a customer to limit access to material on the Internet that is harmful to minors." The customer is not required to accept this child protection service, but the Internet service provider is required to offer it, or risk the state taxes that Section 1101(a) otherwise preempts.

I support the child protection software requirement as a matter of national policy, but, in general, I would not support Congress' attempting to define a limited group of Internet services beyond which states would be free to impose taxes. First, as indicated above, I do not believe there is any set group of services that fairly constitutes "Internet access." There would be many varied opinions as to what should be included or excluded, and any final choice would be largely arbitrary. Second, if a legislative choice were made, and other services were made subject to state taxation, that would burden the evolution and growth of the Internet, because new services would more likely than not fall outside of the group chosen to constitute "Internet access," and, thus, would be subject to taxation. That taxation would inhibit change and innovation, because service enhancements would subject the access provider and its customers to tax and compliance burdens.

Third, the division of the Internet into taxable elements and non-taxable elements would produce many burdens for Internet service providers related to tax administration. Specifically, there would be endless disputes over whether some service or part of a service did or did not fall into the taxable category and how the price paid by the customer could or should be allocated as between taxable and non-taxable elements. Indeed, even the nation's tax administrators acknowledge the reality and seriousness of this problem. For example, the prepared statement of Harley T. Duncan, representing the Federation of Tax Administrators during the April 1 Subcommittee hearing, freely conceded that requiring "Internet service providers to state separately the charges for each particular service sold as part of a package" could "be burdensome for the providers and lead to a number of disputes regarding the manner in which the charges are disaggregated." I concur in that assessment and would urge the Congress not to subject the entire Internet service industry to hundreds of disparate state and local legal interpretations and court fights to resolve what should be a national policy of interstate Internet connectivity, access, innovation and development.

The "$25 Solution" Is Short-Sighted And Will Inhibit Internet Innovation

The problem inherent in defining "Internet access" by a legislatively-determined pre-set group of content and services led the Federation of Tax Administrators to recommend a

rule that "exempts up to $25 of a bill for Internet access," while the "rest of the bill is deemed to be attributable to other services that may or may not be taxable, depending on the laws of the specific state."

There are several reasons why codification of an arbitrary pricing rule, in lieu of a problematic definition of taxable versus non-taxable services, is bad policy. First, the $25 figure was clearly chosen to be about $1 above the current price of America's most popular Internet access provider, America On-Line. Millions of American consumers currently pay about $23.95 each month to log on the Internet using AOL's Internet access services in 2003. The mere passage of time and the natural course of inflation could easily push the price above $25 within a few years, exposing each dollar of service above $25 to state and local taxes, and exposing Internet access to the kind of telephone-tax system the Internet Tax Freedom Act was designed to avoid. Whether state and local telephone-like taxes are imposed upon the first $25 of service or each dollar of service above $25, the basic compliance and administrative burdens and overhead costs will be about the same.

Second, even under prevailing price structures, the $25 figure could be doubled to $50 and still some high-end broadband access providers could find themselves in a legislated catch-22 – hold prices, services and profit margins within $50 or expose their business models to the high administrative costs of collecting and remitting multiple state and local taxes on the $5 or $10 in excess of $50. At the margin, some Internet access providers might decide to withhold services from consumers to avoid diminishing returns in light of the costs of tax compliance. This could inhibit technological innovation and service enhancements.

Third, in order to set a dollar ceiling that would not cause serious market distortions, it would be necessary for Congress accurately to forecast future Internet access market trends and then set the ceiling comfortably above the price reflecting those market trends. However, government has a poor history of success in forecasting future market trends and market prices. That is particularly true in the case of markets based on new and rapidly changing technologies. Consequently, sound policy would counsel against a legislative approach that depends on such forecasting.

Finally, the $25 solution offered by the Tax Administrators, of course, reflects their core philosophy, as stated in Mr. Duncan's written testimony, that "[t]he taxation of charges for Internet Access is a legitimate exercise of state taxing authority and should not be preempted." For all of the reasons stated in my previous testimony before the Subcommittee, and as outlined in the Report of the Advisory Commission on Electronic Commerce (www.ecommercecommission.org), I hold the opposite core view, i.e., that multiple, complex

and costly taxation of interstate Internet services is not a legitimate or constructive exercise of state taxing authority.

State And Local Taxation Of Digital Content
Is Misguided Policy For The United States

At bottom, those who argue that some software and content services should be "unbundled" from Internet router service typically are saying no more than that they prefer for American citizens to pay state and local taxes when they access those online digital services. Because I broadly oppose the Congress allowing states to tax content and communication of the type enabled by the Internet, I see no need to engage in artificial exercises involving the creation of narrow Internet access definitions and related "unbundling."

Proponents of a narrower definition of "Internet access" agree fundamentally with the recent directive of the European Union imposing Value Added Taxes (VAT) on all digital transfers of content and services. The United States currently dominates the world market in digital content, software and services, and we should do nothing to impair our market position. Effective July 1, 2003, the European Union will require all U.S. companies that send content and software via the Internet to European customers to charge and remit VAT (ranging from 15 to 24 percent on each transaction) to the customer's country. The new directive will place U.S. businesses in a competitive disadvantage, and, according to reports, the Administration is considering a legal challenge before the World Trade Organization. As I explained in my testimony on April 1, the United States should not follow the European paradigm in this respect.

Aside from competitive concerns, taxation of digital content will significantly discourage consumers from accessing content on the Internet. The most natural application of the Internet with the greatest commercial and cultural potential will continue to be delivery of services, information, software and entertainment compressed as bits and bytes of electronic data and transferred online from computer to personal computer. Harnessing a myriad of state and local taxes to these electronic packs of data will necessarily encumber the free flow of information. Under the ITFA, all a consumer must do is provide a email account or phone number. But under the "unbundling" system proposed by some, before signing up for access and before each download of information, each consumer will be required to fill out a tax form and provide his nine-digit zip code and pay 5 or 10 percent more for his service. Studies have shown that the more cumbersome and intrusive the interface, the more likely online consumers are to log off rather than complete a transaction.

Furthermore, the taxation of online content, whether bundled or unbundled with router service, necessarily will invade the privacy of people who would like to select online book titles and other personal choices without having to identify themselves and their tax addresses.

An Alternative Solution to Tax "Discrimination"

One "justification" for requiring "unbundling" of router service from other software and content services suggested at the April 1 hearing was the possibility that such services would be non-taxable when bundled with Internet router service and yet taxable when not bundled. The Federation of Tax Administrators expressed concern over such tax "discrimination."

The Advisory Commission on Electronic Commerce addressed this issue and has offered a rational way to resolve anyone's concerns over tax discrimination – in short, prohibit state and local taxes on *all* digital content and services delivered electronically over the interstate Internet medium, whether bundled or unbundled. I have explained the justifications for that policy above, but it suffices to say that this would greatly benefit the American people and encourage further innovation and entrepreneurship.

Narrowing The Definition Of "Internet Access"
Would Amount To A Tax Increase For American Consumers

For five years the Congress has provided a clearly defined and constructive prohibition against taxes on Internet access. Nobody has pointed to any demonstrable abuses of the current definition. And yet, some philosophically pro-tax advocates now suggest Congress should narrow the definition of "Internet access" in a way that will expose people who log on the Internet to new taxes on the services and content they have become accustomed to receiving from access providers without taxes. Because such legislation narrowing the tax protection afforded American consumers would inevitably result in new tax burdens not permitted under current law, any narrowing amendment to the current definition would amount to a tax increase for American consumers.

Identifying A Policy Rationale For
Any State And Local Taxation Of The Internet

Resolving the fundamental issue of what national policy should permit state governments to tax, in my opinion, requires the considered evaluation of the basic role of state and local governments. Increasingly, we are seeing state government initiatives designed to raise money by taxing activities based outside their borders that do not increase the costs of services those local governments traditionally have provided (such as policing, schools or waste management). Often the persons or activities targeted have no vote or other capacity to influence the governmental policies of the states in question. Any such taxation without representation should be inherently suspect.

Our Nation has flourished for many years in a context where information arriving by U.S. mail, over the radio, or by broadcast television is not subject to state taxation. The mere fact that a new medium based on computers makes state taxation seem more feasible does not make it wise or appropriate. The challenge facing our generation has been to limit the growth of the total size of government. Accordingly, I submit, states should be discouraged from raising revenue by taxing human activities based outside their jurisdictions that impose no significant increased costs on traditional state government functions. The Internet and the information services it enables typically do not add costs to traditional state government functions, and, accordingly, Congress should establish a broad and enduring policy against Internet services being burdened by state or local taxation.

I would be pleased to discuss these issues with you and your colleagues in greater detail and thank you for the opportunity to address your Subcommittee.

Sincerely,

James S. Gilmore, III

Former Governor of Virginia
Former Chairman, Congressional Advisory
Commission on Electronic Commerce
Distinguished Fellow, The Heritage Foundation

JG:pml

April 11, 2003

Mr. Jack Kemp
Empower America
1801 K Street, NW
Suite 410K
Washington, DC 20006-5805

Dear Mr. Kemp:

Thank you for appearing before the Subcommittee on Commercial and Administrative Law on April 1, 2003. Your testimony, and the efforts you made to present it, are deeply appreciated and will help guide us in whatever action we take on the issue.

Attached is a copy of the official transcript of this hearing. We have provided this for your review. Please limit any corrections you make to technical, grammatical and typographical errors. This transcript is substantially a verbatim account of remarks actually made during the hearing. No substantive changes are permitted.

Pursuant to the unanimous consent request agreed upon at the hearing, Subcommittee Members were given the opportunity to submit written questions to the witnesses. Accordingly, I request that you respond to the following questions:

- Mr. Duncan states in his testimony that the "fledgling industry" argument with regard to the Internet is no longer valid. How would you characterize the state of the Internet and Information Technology industries? How would H.R. 49 assist the industry as a whole, as well as the participants in it?

Your response to these questions will help inform subsequent legislative action on this important topic. Please submit your written responses to these questions by 5:00 p.m. on Friday, April 25, 2003, to: Diane K. Taylor, Subcommittee on Commercial and Administrative Law, B353 Rayburn HOB, Washington, D.C. 20515. Your responses may also be submitted by e-mail to

diane.taylor@mail.house.gov. If you have any questions, feel free to contact Diane K. Taylor at 202.225.2825. Thank you for your continued assistance.

Sincerely,

CHRIS CANNON
Chairman
Subcommittee on Commercial and Administrative Law

Enclosure

CC: dt

EMPOWER AMERICA

By: Jack Kemp
Co-Director, Empower America
For: Subcommittee on Commercial and Administrative Law House Committee on the Judiciary
Date: April, 25, 2003
Re: Committee Questions Regarding H.R. 49, The Internet Tax Nondiscrimination Act of 2003

Question:

Mr. Duncan states in his testimony that the "fledgling industry" argument with regard to the Internet is no longer valid. How would you characterize the state of the Internet and Information Technology industries? How would H.R. 49 assist the industry as a whole, as well as the participants in it?

Answer:

The "fledgling industry" argument is an important argument for supporting H.R. 49, the Internet Tax Nondiscrimination Act of 2003, making permanent the current Internet tax moratorium on Internet access taxes as well as multiple and discriminatory taxation on the Internet. It is an important argument, but it is not ***the*** argument. That said, to contend that the fledgling industry argument is no longer relevant is to ignore the facts.

The U.S. Department of Commerce released its first ever report on national Web sales on March 3, 2000, in response to the growing importance of e-commerce in the American economy. That report revealed that e-commerce retail sales topped $5.3 billion for the fourth quarter of 1999. However, that report also found that e-commerce revenues accounted for only .64 percent of the total $821.2 billion in U.S. retail sales for the quarter. Thus, I think it was fair to argue the industry was still in the "fledgling" stage during the last round of the Internet tax debate, but where are we today?

Recently, the Department of Commerce released its latest quarterly report on e-commerce. The good news is that e-commerce sales increased by 29.3 percent for the third quarter of the same year. But overall e-commerce sales were merely 1.6 percent of total sales in the fourth quarter and just 1.4 percent of total sales for the year, up a whopping .1 percent from 2001.

There may come a time when e-commerce as a sector of the economy matures, that is our hope, but that time has yet to arrive. In the meantime, Congress would be wise to adopt H.R. 49 to ensure that this industry is not stymied in its infancy.

By adopting H.R. 49 and making the current moratorium on Internet access taxes and multiple and discriminatory taxation on the Internet permanent Congress will be taking an important first step toward ensuring the success of the industry. This bill should be seen as the first part of a broader Congressional strategy to combat anti-competitive tax systems including:

- passage of H.R. 49;
- holding inter-governmental hearings on how and why state and local governments should promote competitive tax reform including reforms such as origin-based methodology for sales tax collection instead of misguided efforts "streamline" sales taxes; and
- Continue efforts to guarantee a "global free trade zone" for electronic commerce.

April 11, 2003

Mr. Harley T. Duncan
Federation of Tax Administrators
Suite 348
444 North Capitol Street, NW
Washington, DC 20001

Dear Mr. Duncan:

Thank you for appearing before the Subcommittee on Commercial and Administrative Law on April 1, 2003. Your testimony, and the efforts you made to present it, are deeply appreciated and will help guide us in whatever action we take on the issue.

Attached is a copy of the official transcript of this hearing. We have provided this for your review. Please limit any corrections you make to technical, grammatical and typographical errors. This transcript is substantially a verbatim account of remarks actually made during the hearing. No substantive changes are permitted.

Pursuant to the unanimous consent request agreed upon at the hearing, Subcommittee Members were given the opportunity to submit written questions to the witnesses. Accordingly, I request that you respond to the following questions:

- Your testimony states that the "fledgling industry" argument when characterizing the Internet is no longer valid. An accurate representation of the Internet and the information technology sector is one which, as a whole, is experiencing serious economic difficulties. Is there any validity in the notion that, rather than promote a nascent industry, H.R. 49 would provide stimulus, stability and predictability to a promising but ailing one?

- You state in your testimony that you are unaware of any States which are considering the imposition of Internet access taxes should the moratorium expire. A recent article in

the San Francisco Chronicle, dated February 8, 2003, reported that the California Controller is considering a tax not only on internet access, but also on software downloads. Please comment on whether such measures have the potential to injure electronic commerce and the IT industry.

Your response to these questions will help inform subsequent legislative action on this important topic. Please submit your written responses to these questions by 5:00 p.m. on Friday, April 25, 2003, to: Diane K. Taylor, Subcommittee on Commercial and Administrative Law, B353 Rayburn HOB, Washington, D.C. 20515. Your responses may also be submitted by e-mail to diane.taylor@mail.house.gov. If you have any questions, feel free to contact Diane K. Taylor at 202.225.2825. Thank you for your continued assistance.

Sincerely,

CHRIS CANNON
Chairman
Subcommittee on Commercial and Administrative Law

CC: dt

Federation of Tax Administrators
444 North Capitol Street, N.W., #348
Washington, D.C. 20001
Ph. (202) 624-5890/Fax (202) 624-7888

April 23, 2003

The Honorable Chris Cannon, Chairman
Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
2138 Rayburn House Office Bldg.
Washington, DC 20515-6216

Dear Mr. Chairman:

This letter responds to your request for answers to two questions regarding H.R. 49 and my testimony thereon at the April 1, 2003, hearing of your Subcommittee. I am glad to respond to the inquiries. First, however, let me thank you once again for the courtesies you showed me at the hearing. As I expressed at the time, I thought the hearing was one of the most informative ones I have attended as either a witness or an observer.

Your first question inquires as to whether, given the economic difficulties facing the information technology industry, the passage of H.R. 49 would provide stimulus, stability and predictability to the industry and thus improve its economic prospects. I would note as a prelude that the economic difficulties in the information technology sector are not the result of state tax policies, but are more likely attributable to overcapacity, difficulty developing profitable business models, general economic conditions and what Chairman Greenspan termed "irrational exuberance."

It is my considered opinion that the passage of H.R. 49 would have only a marginal impact on the economic prospects of the information technology sector. This is especially true with respect to the prohibition on taxes for charges for Internet access that is contained in H.R. 49. Taxes on charges for Internet access are consumer taxes and do not increase the costs of production for Internet service providers. Therefore, the only potential impact on the industry if taxes on access were to be imposed in the absence of H.R. 49 would be a potential impact on the demand for the service because of an increase in cost to the consumer. However, the tax on a normal monthly access fee is likely to be less than $1.00-$2.00 per month (depending on the type of access) compared to an access charge of $15-$50 per month. As the data presented by Rep. Baldwin at the hearing demonstrate there is no consistent, direct correlation between the imposition of a tax on access charges and the proportion of households that purchase Internet access. Other factors are more likely to be dominant in the decision. Thus, I would expect neither the passage of H.R. 49 nor the lack thereof to have a significant impact on Internet service providers and related parties.

I am also skeptical that passage of the "multiple and discriminatory tax" provisions of H.R. 49 will have much of a beneficial impact on the information technology sector. As I mentioned in my testimony, those provisions, for the large part, provide no protections beyond those already accorded taxpayers under existing interpretations of the Commerce and Due Process clauses of the U.S. Constitution by the U.S. Supreme Court. Those Supreme Court precedents require a substantial nexus between a seller and a state before a use tax collection obligation can be imposed. The Internet Tax Nondiscrimination Act attempts to define certain circumstances that will not be considered to create substantial nexus. Given that the Act has not (to my knowledge) been raised as a defense tells me that states are not pursuing the policies proscribed by the Act.

Your second question whether taxes on Internet access or downloads of software (as mentioned by the California Comptroller) "have the potential to injure electronic commerce and the IT industry." Again, the taxes referenced are taxes paid by consumers, and not taxes on production. The only injury to the access provider or the provider of the software would be if their products or services were being taxed and other similar products that could substitute for the access or the software download were not being taxed. In that case, government would be artificially increasing the price of one product and not the other, which would distort buying decisions away from the taxed product or service. In point of fact, the opposite is generally true today. The Internet access and the software download are commonly not taxed items, and they thus benefit from the discrimination when similar substitute products or services are taxed. H.R. 49 proposes to extend the discrimination by making a ban on all taxes on Internet access permanent.

The other injury that could result from taxing access or downloads is if the rules governing the imposition and administration of the tax are not clear, inconsistent or otherwise impose an unreasonable burden on sellers. Through the Streamlined Sales Tax Project and other efforts, states have worked with various segments of the retail industry to develop clear, consistent rules and other simplifications to avoid such undue burdens.

I trust this is responsive to your inquiries. Please do not hesitate to contact me if you or your staff have further questions or require further assistance on this or other matters.

Sincerely,

Harley T. Duncan
Executive Director

April 11, 2003

Mr. Harris N. Miller
Information Technology Association
of America
1401 Wilson Blvd. - Suite 1100
Arlington, VA 22209-2318

Dear Mr. Miller:

Thank you for appearing before the Subcommittee on Commercial and Administrative Law on April 1, 2003. Your testimony, and the efforts you made to present it, are deeply appreciated and will help guide us in whatever action we take on the issue.

Attached is a copy of the official transcript of this hearing. We have provided this for your review. Please limit any corrections you make to technical, grammatical and typographical errors. This transcript is substantially a verbatim account of remarks actually made during the hearing. No substantive changes are permitted.

Pursuant to the unanimous consent request agreed upon at the hearing, Subcommittee Members were given the opportunity to submit written questions to the witnesses. Accordingly, I request that you respond to the following questions:

- In your testimony, you discussed a legal action in which your organization filed an *amicus curiae* brief in response to efforts by a Tennessee State tax official to secure a statutory interpretation which would legitimize the imposition of certain Internet taxes. Please provide further details of this litigation, in particular, what statutory interpretation is sought by the State? What is the current status of this action? Are you currently aware of any similar efforts by other States? What impact would enactment of H.R. 49 have on future litigation of this type?

- You discussed during the hearing 'double taxation' in regard to telecommunications access taxes and their relationship to internet access taxes. Please expand on this concept.

Your response to these questions will help inform subsequent legislative action on this important topic. Please submit your written responses to these questions by 5:00 p.m. on Friday, April 25, 2003, to: Diane K. Taylor, Subcommittee on Commercial and Administrative Law, B353 Rayburn HOB, Washington, D.C. 20515. Your responses may also be submitted by e-mail to diane.taylor@mail.house.gov. If you have any questions, feel free to contact Diane K. Taylor at 202.225.2825. Thank you for your continued assistance.

Sincerely,

CHRIS CANNON
Chairman
Subcommittee on Commercial and Administrative Law

Enclosure

CC: dt

22 April 2003

Honorable Chris Cannon
Chairman, Subcommittee on Commercial and Administrative Law
House Judiciary Committee
B-353 Rayburn House Office Building
Washington, DC 20515

RE: April 11, 2003 Hearings on Internet Taxation

Dear Chairman Cannon:

Thank you for the opportunity to review the record and to provide further information in response to your questions.

1. You ask several questions pertaining to the Tennessee tax action in which ITAA filed an *amicus curiae* brief. For your convenience a copy of that brief is attached. To directly answer your questions:

    a. The State of Tennessee seeks to reverse in a judicial forum an express legislative determination not to impose a sales tax on services such as those offered by online and Internet service providers.

    b. Currently, this action is still being reviewed by the Court of Appeals of Tennessee, Middle Section at Nashville.

    c. We are not aware of any identical actions at the current time. However, similar actions, in the sense that jurisdictions try to tax access are occurring. One very recent example is the Montgomery County, Maryland proposal to tax Internet access. (Please see attached ITAA letter to the County).

    d. The impact of H.R. 49 on litigation of this type would be unclear as the case debates redefinitions of telecommunications rather than Internet access. This approach is not as clear as a straight- forward attempt to impose a tax on access. However, we would believe that ultimately these redefinition efforts would end as the motive, increasing tax revenues by broadening the base, would be eliminated.

2. As mentioned in testimony Internet access is an enhanced information service, built on top of existing telecommunications infrastructure (a distinction long recognized by the Federal Communications Commission). Internet Service Providers and consumers currently pay taxes for their use of telecommunications services. Taxing Internet access would force consumers to pay twice-once for the basic telecommunications service and once for the enhanced information service.

ITAA has been at the forefront of Internet policy even before there was an Internet. Over thirty years ago, in its First Computer Inquiry, the Federal Communications Commission (FCC) began wrestling with what it described as "the growing convergence of computers and communications has given rise to a number of regulatory and policy questions within the purview of the Communications Act." Long before the explosion of ISPs, and the invention of the World Wide Web, the FCC took action that would eventually help pave the way for the nationwide growth of ISPs. In the end, these battles created the regulatory foundation on which the Internet now rests.

One of our continuing battles has been over whether enhanced service providers - or, as the Telecommunications Act of 1996 refers to them, Information Service Providers - should be required to pay access charges. ESPs provide a range of services that allow users to store, provide, and process information. These services range from simple voicemail, to on-line proprietary data bases, to today's Internet access services.

ESPs lease conventional telephone lines from local exchange carriers to receive "calls" from the subscribers. They interconnect these local facilities to packet-based private-line based networks (including the Internet) that carriers the traffic to remote servers. In some cases these servers are in the same state as the end user. In other cases, the servers are in different states. Indeed, in most cases, neither the user nor the ESP knows the locations in which the traffic terminates.

The FCC's long-standing policy has been critical for the growth of the Information Services industry. Internet service providers, for example, can generally charge customers a flat monthly fee for access to the ISP via a local telephone call because the ISP purchases business telephone lines from a local telephone carrier. Customers then dial into a modem bank over lines provided by the local telephone carrier.

The FCC's policy is equitable. ESPs pay the same charges as similarly situated end-users - the subscriber line charge, the business line tariff and, where, applicable, a private-line interconnection charge. A portion of these payments are passed-on, by the local exchange carrier, to the Universal Service Fund.

In the to and fro of the dry, even arcane regulatory battles surrounding access charges, we should not lose sight of the very real practical impact that these cumulative decisions have had on consumers. Seemingly miniscule access charges of 2 or 3 cents per minute would add $20 to $30 per month to the monthly costs of typical Internet consumers. Such charges would:
? Slow adoption of the Internet as a mass-market medium;
? Widen significantly the "digital divide";
? Hinder new, Internet-based businesses and information sources, which would become less attractive due to reduced take-up rates.

If there should be a fundamental principle for Internet public policy, it is to draw upon the wisdom of the Hippocratic Oath - "first do no harm." There is a natural temptation with technology policy to tinker at the margins to reach desired ends. However, the Internet is evolving which such speed and dynamism that even the best-intentioned interventions can have unanticipated negative consequences.

If ITAA can be of further service to you or the Committee please do not hesitate to contact me or Bartlett Cleland of my staff at (703) 284-5310.

Sincerely,

Harris N. Miller
President

ATTACHMENTS

Information Technology Association Of America
Tax

ITAA

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ITAA Echoes President's Call for Senate to Pass Trade Promotion Authority

TAX

ITAA Addresses Montgomery County's Internet Tax Plan

21 April 2003

Councilmember Nancy Floreen
Montgomery County Council
100 Maryland Avenue
Rockville, MD 20850

Dear Ms. Floreen,

On behalf of the Information Technology Association of America (ITAA), representing over 400 companies in the information technology (IT) industry - the enablers of the information economy- I want to express our deep concern regarding Montgomery County's reported plan to begin taxing Internet access and particularly broadband Internet access. Our members are located in every state in the United States, including Montgomery County, Maryland, and range from the smallest IT start-ups to industry leaders in the custom software, services, systems integration, telecommunications, Internet, and computer consulting fields

Taxing Internet access is bad public policy for a variety of reasons. First, although doing so effectively raises the costs for all income levels, it would inhibit Internet use by those least able to pay, thus foreclosing digital opportunities. In particular, the plan expressly calls for taxation of the next generation of Internet access, keeping those least able to pay on the sidelines of innovation and the future.

Second, Internet access is an enhanced information service, built on top of existing telecommunications infrastructure (a distinction long recognized by the Federal Communications Commission). Internet Service Providers and consumers currently pay taxes for their use of telecommunications services. Taxing Internet access would force consumers to pay twice—once for the basic telecommunications service and once for the enhanced information service.

Third, by taxing access and thereby raising the cost of Internet service, lawmakers risk suppressing demand for broadband and network-enabled innovations at "the edge of the network." ITAA believes every dollar invested in broadband use delivers a substantial contribution to the economy, expressed in terms of new capital spending, productivity gains, next generation products and services, new business models and employment.

Fourth, the Internet Tax Fairness Act places a moratorium on taxing Internet access. The plan to tax broadband, or Internet access, violates the principles of this critical piece of federal legislation.

While other jurisdictions strive to make Internet access widely available to all consumers, Montgomery County, long recognized as a leader in progressive public policies, runs the risk of

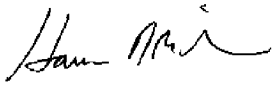
erecting economic barriers to the Internet's widespread adoption. Many Virginia communities, for example, have made Internet adoption part of a strategy to reduce transportation congestion by increase tele-working.

We sincerely hope that you will reconsider this plan. While we do sympathize with the budget difficulties in Montgomery County, and in jurisdictions throughout the country, we reject the notion that radical increases in taxes are the best means to ensure an economically sound future. Said another way, present plans to tax the future can only result in bankruptcy.

If ITAA may be of any assistance, please do not hesitate to contact me (703/284-5340; hmiller@itaa.org), or Bartlett Cleland of my staff at (703/284-5310; bcleland@itaa.org).

Thank you for considering the IT industry's views.

Sincerely,



Harris N. Miller
President

APPEAL NO. M2002-00918-COA-R3-CV

IN THE COURT OF APPEALS OF TENNESSEE
MIDDLE SECTION AT NASHVILLE

PRODIGY SERVICES CORPORATION
Plaintiff/Appellee

v.

RUTH E. JOHNSON
Commissioner of Revenue,
State of Tennessee,
Defendant/Appellant

APPEAL
FROM THE CHANCERY COURT FOR DAVIDSON COUNTY, TENNESSEE
CIVIL ACTION NO. 98-1051-III

BRIEF OF *AMICI CURIAE* INFORMATION TECHNOLOGY ASSOCIATION OF AMERICA AND U.S. INTERNET SERVICE PROVIDERS ASSOCIATION IN SUPPORT OF APPELLEE

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INTEREST OF AMICI CURIAE

Amicus Information Technology Association of America ("ITAA"), <http://www.itaa.org>, is the principal trade association of the computer software and service industry, representing the broad interests of U.S. businesses engaged in the Information Technology (IT) industry. IT is one of America's fastest growing industries, encompassing computers, software, telecommunications products and services, Internet and online services, systems integration, and professional service companies. ITAA has 500 member companies located throughout the United States, ranging from major multinational corporations to small, locally based enterprises. In particular, ITAA's members include a significant number of Internet service providers and online service providers which market enhanced and value added services to the public; services which

are distinct from those furnished by basic telecommunications providers. ITAA was an active participant, testifying before the Business Tax Study Committee, in the March 1993 legislation which eliminated value added networks from the definition of telecommunications services that are subject to Tennessee sales tax.

Amicus U.S. Internet Service Providers Association ("US ISPA"), <http://www.usispa.org>, is a national trade association that represents the interests of companies that operate Internet networks and/or provide a variety of different Internet and online services. A principal purpose of US ISPA is to represent its members before federal and state agencies, courts, and legislatures in matters of common concern. US ISPA board members include experts in all facets of the industry. Their combined experience gives US ISPA a unique understanding of the practical, as well as, legal considerations relevant to the proper interpretation and application of Internet-related laws.

ITAA and US ISPA and their members have a strong interest in the fair tax treatment of online and Internet service providers, which is threatened in this case. Faced with ballooning budget deficits, several state and local governments have attempted to reach out and tax online and Internet services under general statutes that were never intended to reach those services. This case presents a particularly egregious example. The Tennessee Department of Revenue ("the Department") is seeking here to tax Prodigy's online services as "telecommunications services" - even though online services are not telecommunications under any ordinary understanding of that term and despite the General Assembly's unambiguous intent to exclude these services from taxation.

Amici and their members agree with the arguments made by Prodigy that its online services are best viewed under Tennessee law as nontaxable information services (Appellee's Br. at 32-38), and that under a plain language reading of the statute, online

service providers like Prodigy, which do not own or operate the underlying transmission services, do not sell taxable telecommunications services (Appellee's Br. at 20). Amici have no wish to duplicate those arguments. Instead, amici tender this brief to provide the Court context, beyond the specific facts of this case, regarding the historical development, nature and scope of online and Internet services, and to focus specifically on the statutory and legislative history of Tennessee's tax on telecommunications services. That history (to which ITAA was an eyewitness) demonstrates conclusively that the General Assembly did not intend this tax to reach online and Internet services.

SUMMARY OF ARGUMENT

In this appeal, the Commissioner inappropriately seeks to reverse in a judicial forum an express legislative determination *not* to impose a sales tax on services such as those offered by online and Internet service providers. Industry, the Department, and members of the General Assembly hotly debated the policy arguments and revenue consequences associated with taxing such services in 1989, and again in 1992. The General Assembly expressly stated an intention not to sweep this array of services into the "furnishing" of "telecommunications services" subject to sales tax. The Commissioner should not be seeking a different result in this Court.

When the statute was first amended in 1989 to impose a tax on inter- (as well as intra-) state telecommunications services, the General Assembly defined telecommunication in an open-ended way to capture emerging technologies, such as beepers, pagers, and mobile phones. There is no evidence that the General Assembly considered taxing online or Internet services - which is unsurprising since these are not commonly viewed as forms of telecommunications, online services were then in their infancy, and at the time the commercial Internet did not yet exist. The statute did include value added networks, or "VANs," as a species of telecommunication, but the term was

undefined and had no generally accepted meaning.

The statute was amended in May 1992 to define VANs. The term was defined to include high speed data transmission networks and enhanced transmission services, such as in-network storage applications and electronic mail ("e-mail"). Thus defined, VANs (and, hence, telecommunication) could have been interpreted to encompass certain aspects of online or Internet services, such as e-mail. On the other hand, members of the General Assembly took pains to emphasize that the statute was intended to tax only the transmission of information, not the information itself, so its application to online and Internet services was unclear. In either event, this legislation unquestionably was the closest the General Assembly had ever come to imposing a sales tax on online and Internet services.

This high-water mark was short-lived. Ten months after adding this expansive definition of VANs, the General Assembly heeded industry's complaints and amended the statute once again, this time to delete all reference to VANs. The legislative history makes clear that the General Assembly intended through this deletion to exclude VANs from taxation. And it demonstrates equally, that despite the current Commissioner's protestations, the Commissioner who advised the General Assembly in 1992 understood perfectly well that henceforth VANs (including enhanced services such as e-mail) would no longer be subject to tax. This legislative history demolishes the current Commissioner's attempt to construe telecommunication to encompass online and Internet services.

The Commissioner does not dispute any of this, but argues that the Court must ignore the General Assembly's actual intentions. None of the cases she cites bears that out. To the contrary, the cases emphasize the Court's obligation to ascertain and give effect to the intention and purpose of the General Assembly.

BACKGROUND

The Internet grew out of research in computer networking and telecommunications that began in the late 1960s. *See* Janet Abbate, *Special Issue: Computers and Communications Networks*, 75 Bus. His. Rev. 147 (2001) (Appendix ("App.") at 89-105). During the 1970s and 1980s, it primarily served as a data and communications network for military and educational institutions. *Id.*

Online services developed simultaneously, but largely on a separate track, fueled by the explosive growth in home computer use. *Id.* (App. at 98). During the mid-1980s, online service providers ("OSPs") began to offer limited data transfer capabilities to subscribers through proprietary computer networks. *Id.* Because of the technological limitations of computers and modems at that time, these capabilities were mostly text-based with limited or no graphical interfaces. *Id.* An OSP was "a primarily captive universe (albeit a very large one) in which the expectation [was] that users [would] play within the confines of the local schoolyard."

After the birth of the commercial Internet in 1991, *see* Abbate (App. at 101), OSPs began to offer their subscribers Internet access and e-mail as an adjunct to their proprietary features, which typically included chat rooms, electronic bulletin boards, educational reference materials, world news, personal financial information, travel tips, hobby forums, and information pertaining to the arts. At the same time, Internet service providers ("ISPs") began to offer other users the option of a more basic gateway to the Internet. In providing their services, OSPs and ISPs often give subscribers the ability to expand, limit, and customize the information that they receive online or via e-mail through a mix of parental controls, spam blocks, and user-created start pages. Moreover, their e-mail, chat rooms and electronic bulletin boards often are formulated to enhance a subscriber's experience with a distinctive and pleasing "look and feel."

To provide their subscribers access to their proprietary computer networks and Internet gateways, OSPs and ISPs provide subscribers with software and technical support. However, they typically do not transmit information to their subscribers. Rather, they ordinarily contract with third parties, termed network service providers ("NSPs"), to transmit data to and from their computer networks. Subscribers generally obtain access to these data networks by calling a local telephone number to connect to a point of presence ("POP"). The subscriber is responsible for all local exchange carrier charges incurred to make that connection. The NSP is then responsible for routing data from a modem located at the POP through its data networks to the proprietary computer networks operated by the OSP or ISP.

The Commissioner's briefs focus on aspects of online and Internet services that are "communicative" in nature, such as chat rooms and e-mail, in arguing that these services should be viewed as taxable "telecommunications" services. (Appellant's Br. at 11-15, 21-28, 29-32; Appellant's Reply Br. at 11, 14-17.) This argument is misguided. Regardless of whether aspects of the services are conceptually communicative, the statutory and legislative history of Tennessee's tax on telecommunications services makes it crystal clear that the General Assembly did not intend to extend the sales tax to online and Internet services.

ARGUMENT

I. THE STATUTORY AND LEGISLATIVE HISTORY DEMONSTRATES THAT THE GENERAL ASSEMBLY DID NOT INTEND TO TAX ONLINE AND INTERNET SERVICES AS TELECOMMUNICATIONS SERVICES

The starting point for this Court's analysis is that any doubts as to the application of the sales tax to the taxpayer's services must be strictly construed against the Commissioner. In *Union Carbide Corp. v. Alexander*, 679 S.W.2d 938 (Tenn. 1984),

the Tennessee Supreme Court articulated the fundamental rules of statutory construction in tax cases as follows:

> It is fundamental in this jurisdiction that statutes levying taxes or duties on citizens will not be extended by implication beyond the clear import of the language used, nor will their operation be enlarged so as to embrace matters not specifically named or pointed out. Doubts as to the application of tax statutes will be resolved in favor of the citizen and tax statutes will be construed *most strongly* against the state.

Id. at 942 (citations omitted) (emphasis added); *accord Covington Pike Toyota, Inc. v. Cardwell*, 829 S.W.2d 132, 135 (Tenn. 1992); *see also Morton Pharmaceuticals, Inc. v. McFarland*, 212 Tenn. 168, 176, 368 S.W.2d 756, 759 (1963) ("In interpreting statutes and applying them in these revenue cases, we must keep in mind that doubtful language in taxing statute should be resolved in favor of the taxpayer.").

For all of the reasons discussed below, the Commissioner in this case has failed to establish that Prodigy's online services are telecommunications services subject to Tennessee's sales tax.

A. The Tax On Telecommunications Services Enacted In 1989 Was Not Intended To Reach Online And Internet Services

1. The Statutory Definition Of "Telecommunication" In 1989 Did Not Mention Online Or Internet Services

In the wake of the Supreme Court's decision in *Goldberg v. Sweet,* the General Assembly made furnishing inter- (as well as intra-) state telecommunications services subject to Tennessee's sales tax. *See* 1989 Tenn. Pub. Acts Ch. 312, § 5 (App. at 19-20), *enacting* Tenn. Code Ann. § 67-6-102(22)(F)(iii) (1989) (App. at 9). For these purposes, "telecommunication" was defined as "communication by electric or electronic *transmission* of impulses," including "*transmission* by or through any media such as wires, cables, microwaves, radio waves, light waves or any combination of those or

similar media." Tenn. Code Ann. § 67-6-102(27)(A) (1989) (App. at 12) (emphasis added). The General Assembly instructed further that telecommunication would include:

> all types of telecommunication *transmissions*, such as telephone service, telegraph service, telephone service sold by hotels or motels to their customers or to others, telephone service sold by colleges and universities to their students or to others, telephone service sold by hospitals to their patients or to others, WATS service, paging service, value added networks, and cable television service sold to customers or to others by hotels or motels.

Id. § 67-6-102(27)(B) (App. at 12) (emphasis added).

Importantly, this original 1989 statute focused on *transmission* and did not specify or advert to online or Internet Services.

2. The Commissioner Has Not Demonstrated That The General Assembly Intended By Its General Definition of "Telecommunication" To Tax Online Or Internet Services

The Commissioner insists that the definition of telecommunication enacted in 1989 was quite broad (Appellant's Br. at 52-55), but there is no reason to believe the General Assembly intended that broad definition to reach online or Internet services.

To begin with, because the statutory definition of telecommunication focuses on *transmission*, an activity not typically performed by OSPs or ISPs, the definition does not encompass such services, as a matter of pure textual analysis.

More generally, the legislative history makes it plain that the General Assembly in 1989 did not contemplate taxing online or Internet Services. At the time, several new telecommunications technologies recently had emerged. The legislative history mentions specific technological developments for the transmission of voice and data, including beepers, WATS lines, cellular phones, mobile phones, private lines, and facsimile transmissions. It is sensible to read the broad language of the 1989 statute to encompass those emerging telecommunications technologies that it specifically mentioned. But there is no similar reference in the legislative history to online or Internet-related

technologies. This is unsurprising. Not only were such services not commonly described or viewed as telecommunications, but in 1989 online services were still in their infancy and the Internet was not yet available for commercial use.

Where the General Assembly has neither envisioned nor considered an issue, the "[c]ourt cannot expand the scope of a statute to create results not intended by the legislature." *State v. Alford*, 970 S.W.2d 944, 947 (Tenn. 1998). Here, viewing the 1989 legislation from a historical perspective - as it must be viewed - it is simply bizarre for the Commissioner to suggest that the General Assembly *intended* to reach online or Internet providers by enacting a tax on telecommunications services.

B. The Tennessee General Assembly's Amendment Of The Statute In May 1992 To Include Electronic Mail And Other Enhanced Transmission Services Was The Closest The General Assembly Ever Came To Taxing Online And Internet Services

The 1989 statute included value added networks, or "VANs," in the definition of telecommunications services subject to tax but did not define that term. The General Assembly amended the statute in May 1992 to expressly define VANs as:

> [A] network which sells to third parties high-speed data transmission services through a public packet-switched network. VANs also provide various enhanced transmission services such as information transport/access among incompatible data devices or computers, in-network storage applications and electronic mail services. The commissioner will define enhanced transmission services within the rules and regulations.

1992 Tenn. Pub. Acts. Ch. 1007, § 1 (App. at 23), *codified at* Tenn. Code Ann. § 67-6-102(31) (1992 Supp.) (App. at 16) (emphasis added).

This definition could have been read to encompass certain aspects of online and Internet services, because OSPs store a tremendous amount of data on their proprietary computer networks, and e-mail has always been a component of online and Internet services. On the other hand, the General Assembly clearly intended the tax on VANs to

reach only the transmission of communications, and not the content included in transmission. *See* Transcript of Senate, Finance, Ways and Means Committee Hearing, April 14, 1992 (App. at 54-57) (Statement of Sen. Rochelle: "What this tries to do is to clarify that our intent was to tax telecommunications, not to tax content of the communications." (App. at 56)). Thus, it is doubtful that the General Assembly ever intended to tax content-based services such as those offered by OSPs and ISPs. In any event, the May 1992 legislation was the closest the General Assembly ever came to extending the sales tax to telecommunications services.

C. The Commissioner's Argument That Telecommunications Services Encompass Online And Internet Services Is Demolished By The General Assembly's Deletion Of VANs From The Definition Of Telecommunication Services In March 1993

Six months after the new VANs definition was enacted, industry representatives appeared before the Business Tax Study Committee and testified that VANs, and specifically enhanced transmission services, should not be taxable at all in Tennessee. *See, e.g.*, Testimony of Jeannie Schaaf of BT North America on behalf of Information Industry Association and ITAA, Transcript of Business Tax Study Committee, October 27, 1992 (App. at 59-61). The General Assembly acceded to this request and eliminated VANs entirely from the definition of telecommunication. *See* 1993 Tenn. Pub. Acts Ch. 51, §§ 2 and 3 (App. at 25).

The legislative history of this amendment makes crystal clear that, by deleting the reference to VANs, the General Assembly intended to make VANs non-taxable. As Senator Rochelle explained:

> [T]his bill is one that addresses the telecommunications tax that we passed three or four years ago, and clears up a couple of difficulties that we've had . . . . I think everyone agrees this needs to be done. It will, in essence, *the prime thing it does is eliminate value added networks from taxation*. The reason for that is, is that nobody has been able to determine what a value added network is. And with the fast paced changes in the

> telecommunications business, this is causing us difficulty in that folks don't know whether they can do something or can't do something whether it might end up being called a value added network.

Floor Debate on Senate Bill 157 before the Senate, 98th General Assembly, 1st Reg. Sess. S-19, February 25, 1993 (App. at 85) (emphasis added). The General Assembly was well aware that this would reduce the State's future tax revenue. *See* Transcript of Business Tax Study Committee, October 27, 1992 (App. at 58-80) (Statement of Sen. Henry: "I know we're not talking about any lost revenue. We are however talking about foregoing revenue . . ." (App. at 63)).

The legislative record makes it equally clear (to the extent there could be any question) that, by eliminating VANs from the definition of telecommunication, the General Assembly intended to eliminate taxation of e-mail and enhanced transmission services, which were part of the VANs definition. *See* Transcript of Senate Finance, Ways and Means Committee, February 23, 1993 (App. at 81-83) (Statement of Sen. Rochelle: "This would remove the language enhanced transmission services and also value added networks." (App. at 82)).

And while the current Commissioner argues otherwise, her predecessor understood full well this consequence of the 1993 amendment. Advising the Business Tax Study Committee at the time about the effect of removing VANs from the taxing statutes, Commissioner Huddleston stated that such action "would reduce the area that we're currently taxing in that segment of telecommunications. It would remove value added networks from the area that we're currently taxing." *See* Transcript of Business Tax Study Committee, October 27, 1992 (App. at 64).

II. THE COMMISSIONER ERRS IN URGING THIS COURT TO IGNORE THE LEGISLATIVE AND STATUTORY HISTORY OF THE MARCH 1993 AMENDMENT WHICH SHOWS UNEQUIVOCALLY THAT THE GENERAL ASSEMBLY DID NOT INTEND TO TAX ONLINE AND INTERNET SERVICES

The March 1993 amendment put to rest any argument that the telecommunications services tax is meant to reach the communicative aspects of online and Internet services, such as chat rooms or e-mail. The Commissioner does not disagree. But she insists that this Court must ignore that definitive evidence of the General Assembly's intent. According to the Commissioner, *Tobin v. Estes*, 168 Tenn. 403, 79 S.W.2d 550 (1935), bars this Court from concluding that, by its elimination of VANs from the definition of telecommunication, the General Assembly intended to exclude VANs from taxation. (*See* Appellant's Br. at 72.) This argument is meritless.

Tobin held only that the elimination of a clause specifically including an item within a taxable category does not *by itself* prove an intent to exclude the item from taxation, where the item is not added to an existing list of express exclusions. *See Tobin*, 168 Tenn. at 408-10, 79 S.W.2d at 552. *Tobin*'s holding is perfectly sensible, as the deletion of an express inclusion, without more, is ambiguous: it could mean either an intent to exclude the item from taxation or, perhaps, just an intent to eliminate unnecessary verbiage. But the holding in *Tobin* has no application in situations like this, where the legislative history eliminates any ambiguity and makes perfectly clear that the General Assembly intended by eliminating VANs from the definition of telecommunication to bar the taxation of VANs (including email and other enhanced transmission services). *See, e.g., Univ. Computing Co. v. Olsen*, 677 S.W.2d 445 (Tenn. 1984) (citing legislative history to show purpose behind General Assembly's enactment); *Wilds v. Coggins*, 496 S.W.2d 460 (Tenn. 1973) (stating that legislative history demonstrated intent of General Assembly).

Contrary to the Commissioner's argument, the General Assembly's elimination of VANS from the definition of taxable telecommunications services constitutes an interpretive directive "too significant to be escaped." *Memphis Natural Gas Co. v. McCanless*, 180 Tenn. 695, 700, 177 S.W.2d 843, 845 (1944) (recognizing the principle of statutory construction that, where a statute originally excluded certain earnings from tax but was later amended to delete the exclusion, the subsequent omission of that provision could not be ignored in construing the amended statute). Where the legislative history makes clear the General Assembly's intent to exclude an item from tax by eliminating an express inclusion, as it did here, the holding of *Tobin* is inapposite and the demonstrated intent of the General Assembly must control. *See, e.g., Van Tran v. State*, 66 S.W.3d 790, 820 (Tenn. 2001) ("A cardinal rule of statutory construction is that courts should seek to ascertain and give effect to the intention and purpose of the General Assembly."); *S. Constructors, Inc. v. Loudon County Bd. of Educ.*, 58 S.W.3d 706, 713 (Tenn. 2001) (citing *Dorrier v. Dark*, 540 S.W.2d 658, 659 (Tenn. 1976) ("All rules of statutory interpretation have only one purpose, and that is to ascertain legislative intent.")). Since the statutory definition of telecommunication must be construed most strongly against the Commissioner, and she has not demonstrated that Prodigy's online services are included in this definition, the Court should rule in Prodigy's favor in this case.

CONCLUSION

For the reasons stated above, amici respectfully submit that this Court should affirm the decision of the Chancery Court.

Dated: March __, 2003

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing is being forwarded **via U.S. Mail, postage prepaid,** to:

Margaret M. Huff Assistant Attorney General Office of the Attorney General, Tax Division P.O. Box 20207 Nashville, TN 37202-0207 *Counsel for Defendant/Appellant* Charles A. Trost WALLER LANDSDEN DORTCH & DAVIS Nashville City Center 511 Union Street, Suite 2100 Nashville, TN 37219-1760 *-and-* Peter J. Brann BRANN & ISAACSON 184 Main Street P.O. Box 3070 Lewiston, ME 04243-3070 *Counsel for Plaintiff/Appellee*

on this the _____ day of _____, 2003.

_____

PREPARED STATEMENT OF GROVER NORQUIST

Chairman Cannon and other members of this committee, thank you for the opportunity to address you regarding H.R. 49, the Internet Tax Non-Discrimination Act.

My name is Grover Norquist and I am president Americans For Tax Reform (ATR), a non-partisan, not-for-profit non-partisan coalition of taxpayers and taxpayer groups who oppose all federal and state tax increases. I submit my comments to you today in strong support of a permanent moratorium on taxing Internet access.

In 1998 Congress acted to put to an end taxes that unfairly single out the Internet. However, the current moratorium is scheduled to expire on November 1, 2003, unless Congress acts to eliminate taxes on Internet access, double-taxation of a product or service bought over the Internet, and discriminatory taxes that treat Internet purchases differently from other types of sales. Fortunately, H.R. 49 meets all of the above criteria.

In addition, Representative Cox's legislation ensures that the permanent moratorium on Internet access taxes applies to all 50 states. Unfortunately, the original moratorium enacted in 1998 and extended in 2001 contained a grandfather clause, which permitted a few jurisdictions already taxing Internet access to continue to do so. In an effort to protect consumers that use the Internet, the Internet Tax Non-Discrimination Act strikes the grandfather clause. *Federal law should no longer reward those tax authorities that rushed to be the first ones to tax Internet access.*

ATR has always been supportive of a permanent ban on Internet taxes, and supported a two-year extension only as a compromise solution. While last years extension was a disappointment, the House of Representatives should take the opportunity to permanently extend the moratorium in order to keep access taxes off of the Internet. *Therefore, Congress should ensure that there is no state sales tax simplification added on to the current legislation.*

A sales tax on Internet purchases, at this time, would be harmful to electronic commerce and the economy as a whole. Internet taxation will limit the expansion of electronic commerce and in effect, hinder economic growth. Moreover, there is no evidence at this time that Internet sales are hurting state sales tax revenue, since Internet purchases represent only a small 2% of total retail sales.

Contrary to some arguments, taxing the Internet will actually hurt Main Street businesses far more than it will help them. Internet access has allowed Main Street businesses to link into a worldwide market, which has the potential to increase market share for small businesses and offer consumers more choice. *To allow states to tax Internet commerce will hurt the very people that some politicians and other interest groups are claiming to help.*

ATR advocates for the speedy consideration of the Internet Tax Non-Discrimination Act. If Congress does not pass a new ban on Internet access taxes and multiple and discriminatory taxes it will mean a defacto tax increase on Americans at a time when they least are able to pay it. Not only that, this tax will hit schools, libraries, hospitals and families—those who use the Internet for research, education, and most critically, communication. This is not the time to be adding a new tax on Americans trying to keep in touch with loved ones. *Therefore, ATR supports a clean extension of the moratorium, without sales tax simplification language.*

Enacting a permanent moratorium on taxing Internet access will have significant benefits to the United States economy and increase the standard of living for all Americans. Ultimately, Congress has an opportunity to help American workers, individual shareholders, and all individuals by reducing the cost Internet access.

On behalf of Americans for Tax Reform, I urge your committee to quickly pass this needed legislation.

PREPARED STATEMENT OF ROBERT HOLLEYMAN

Mr. Chairman and Members of this Committee,

Thank you for the opportunity to provide written comments on H.R. 49, the Internet Tax Nondiscrimination Act. I am the President and CEO of the Business Software Alliance. The Business Software Alliance *(www.bsa.org)* is the foremost organization dedicated to promoting a safe and legal online world. BSA is the voice of the world's commercial software industry and its hardware partners before governments and in the international marketplace. Its members represent the fastest growing industry in the world. BSA programs foster technology innovation through education and policy initiatives that promote copyright protection, cyber security, trade and e-commerce. BSA members include Adobe, Apple, Autodesk, Avid, Bentley Systems, Borland, Cisco Systems, CNC Software/Mastercam, Entrust, HP, IBM, Intel, Intuit,

Internet Security Systems, Macromedia, Microsoft, Network Associates, Novell, PeopleSoft, SeeBeyond, Sybase and Symantec.

BSA believes that the Internet has transformed American society. Individuals and businesses now have available to them vast sources of information that have revolutionized how Americans obtain goods and services and American businesses deliver them. One of the reasons for the success of the Internet has been the efforts of Congress in the past to ensure that the it is not taxed in a discriminatory manner. This precedent set by Congress in 1998 should continue permanently and endorse the passage of H.R. 49.

In particular, I see the nondiscrimination issue from a worldwide perspective as the head of an international technology trade association. BSA members have been opposed to any efforts to discriminate against the Internet as a delivery mechanism for goods and services. We have worked with the United States Government and other member countries of the World Trade Organization to harmonize and reduce tariffs in order to increase free trade across the globe. As the New Economy continues to spread and grow, there is no doubt that the United States will be a leader in using the Internet to deliver goods and services to the world.

Recognizing American leadership in technology, some foreign governments have viewed Internet delivered goods and services as a source of an additional taxing opportunity that burdens American companies more than domestic ones. We have and will continue to oppose such discrimination by foreign governments. Passage of the Internet Tax Nondiscrimination Act will send a strong signal to the world that America puts it money where its mouth is. By showing that we view the Internet as an equal partner to offline transactions and oppose any efforts to treat it differently.

This legislation deserves the full support of Congress and the nation to ensure that the Internet continues to thrive around the world. I thank you for the opportunity to provide written testimony at today's hearing.

INFORMATION TECHNOLOGY INDUSTRY COUNCIL

1250 Eye Street, NW Suite 200
Washington, DC 20005
202-737-8888 www.itic.org

March 25, 2003

The Honorable Christopher Cox
United States House of Representatives
Washington, DC 20510

Dear Representative Cox:

I am writing to thank you for your leadership on H.R. 49, the Internet Tax Nondiscrimination Act, to permanently extend the current moratorium on Internet access taxes and discriminatory taxes on electronic commerce. We strongly support this legislation and believe that extending the moratorium this year is a key component to ensure the future growth of the Internet and the nation's economy.

As the Congress considers the merits of extending the moratorium, we believe it imperative to keep in mind that the moratorium does not apply to state sales taxes; it is a moratorium on "Internet access" taxes and "discriminatory taxes on electronic commerce" alone. Extending the existing moratorium will not prohibit any state from collecting sales taxes under existing law. Absent an extension of the moratorium, however, millions of Internet users could find new taxes on their monthly Internet access bills. Similarly thousands of taxing jurisdictions may begin to apply discriminatory taxes on e-commerce transactions that would be unfair and regressive.

There are many complex issues surrounding the simplification of state sales taxes, and we support efforts to develop a long-term solution that will significantly simplify state sales tax regimes. Development of such a solution will take time, but these issues are not interconnected and Congress must act to extend the moratorium with or without a solution to the state sales tax simplification question.

ITI is the association of leading U.S. providers of information technology products and services. It advocates growing the economy through innovation and supports free-market policies. ITI members have worldwide revenues of more than $668 billion and employ more than 1 million people in the United States.

We look forward to working with you on this issue.

Best regards,

/s/
Ralph Hellmann
Senior Vice President

April 8, 2003

The Honorable Chris Cannon
Chairman
Subcommittee on Commercial
& Administrative Law
Committee on the Judiciary
U.S. House of Representatives
B-353 RHOB
Washington, D.C 20015

The Honorable Melvin L. Watt
Ranking Member
Subcommittee on Commercial
& Administrative Law
Committee on the Judiciary
U.S. House of Representatives
B-353 RHOB
Washington, D.C 20015

Dear Mr. Chairman and Ranking Member:

I respectfully request that my written statement on behalf of the Cellular Telecommunications & Internet Association be included as part of the record of the Subcommittee's April 1, 2003 legislative hearing on H.R.49, the Internet Tax Non-Discrimination Act.

The wireless industry looks forward to working with you and the other members of the subcommittee as you consider H.R.49.

Sincerely,

Steven K. Berry

PREPARED STATEMENT OF STEVEN K. BERRY

Thank you for the opportunity to submit written testimony for the record of the Subcommittees hearing on H.R.49, the Internet Tax Non-Discrimination Act. The Cellular Telecommunications & Internet Association (herein, CTIA) represents all categories of commercial wireless telecommunications carriers, including cellular and personal communications services, manufacturers and wireless Internet providers.

CTIA supports the goals of the Internet Tax Non-Discrimination Act. Our concern, however, is that the law as written in 1998 does not accommodate the technological changes that are driving the marketplace in 2003—and that will continue to drive the market in new directions in the years ahead.

CTIA supports two clarifications in the law that, in our view, are consistent with the original intent of the Internet Tax Freedom Act: first, that the moratorium on Internet Access applies equally to all providers of Internet Access; and second, that the prohibition on multiple and discriminatory taxes on electronic commerce applies equally to all sellers of such products and services, including telecommunications companies.

The current definition of "Internet Access" in Section 1104 reads as follows:

> (5) INTERNET ACCESS.—The term "Internet access" means a service that enables users to access content, information, electronic mail, or other services offered over the Internet and may also include access to proprietary content, information, and other services as part of a package of services offered to users. *Such term does not include telecommunications services. (Emphasis added.)*

Wireless carriers are concerned that the exclusion of "telecommunications service" from the definition of Internet Access will result in wireless Internet Access and electronic commerce products being deemed taxable while competing services are tax exempt. This disparity places CTIA's member companies at a significant competitive disadvantage when they seek to sell Internet Access and electronic commerce products and services.

Today, the wireless industry offers wireless Internet Access and numerous electronic commerce products. Wireless Internet Access includes both web access from handsets and other handheld devices. Wireless Internet Access is also provided using handsets or other devices as wireless modems for laptop or desktop computers. Electronic commerce products include downloaded software and other digital products (such as, ring tones and games) and information services (such as, stock quotes and sports scores).

As new wireless third-generation ("3G") technologies are deployed, wireless Internet Access and other e-commerce products and services will increasingly be competing with other types of Internet Access and e-commerce products sold through other channels. These competing services may include digital subscriber line (DSL) Internet Access offered by telecommunications companies, cable modem service offered by cable companies, direct satellite Internet Access, and e-commerce services offered Internet service providers.

Subjecting part or all of a wireless carrier's charges for Internet Access to state and local taxation is a significant tax burden on customers and is contrary to the intent of the Internet Tax Non-discrimination Act. The effective tax rate on telecommunications companies and their customers averages more than 17% as compared to 6% for other businesses according to a recent study completed by the Council on State Taxation.

We believe that these discriminatory telecommunications taxes, if applied to our Internet Access and electronic commerce products and services, would seriously harm our ability to compete with other Internet Access providers by making it more expensive for consumers to access the Internet through wireless networks than through other technologies. This would, in turn, slow the deployment of the wireless broadband infrastructure and slow the roll out of new wireless products and services that have the potential to bring dramatic new productivity improvements to the entire economy.

Recent economic studies further highlight the potential ill effects of these discriminatory telecommunications taxes. These studies document that the demand for wireless services is very price sensitive. Technological advancement and fierce competition among wireless companies have resulted in more affordable service for a larger number of consumers. However, because demand for wireless services is very price sensitive, increases in the cost of service attributable to discriminatory taxes are likely to result in consumers forgoing the purchase of additional wireless services or forgoing the choice to become a wireless customer.

It is unfortunate that legislation designed to prevent multiple and discriminatory taxation of Internet and Electronic Commerce specifically excludes the one service that is absolutely vital to the functioning of the Internet—the telecommunications backbone—and the one service that is subject to one of the highest discriminatory state and local tax burdens in the country.

When considering reauthorization of the Internet Tax Non-Discrimination Act, CTIA strongly urges Congress to clarify the definition of Internet Access to both remove uncertainty and create tax parity for all providers of Internet Access and sellers of electronic commerce products and services. CTIA looks forward to working with the Committee on legislation that will accomplish these important changes.

PREPARED STATEMENT OF ALLTEL, AT&T, AT&T WIRELESS, CINGULAR, LEVEL 3, SPRINT, T-MOBILE, VERIZON, VERIZON WIRELESS, BELLSOUTH, AND SBC

Thank you for the opportunity to submit written testimony for the record on the Internet Tax Non-Discrimination Act.

Our companies support the goals of the Internet Tax Non-Discrimination Act. Our concern, however, is that the law as written in 1998 does not accommodate the technological changes that are driving the marketplace in 2003—and that will continue to drive the market in new directions in the years ahead. Specifically, we believe that the definition of Internet Access in the Act needs to be re-written to ensure that all providers of Internet Access are treated equally under the moratorium.

We all know that rapid technological changes have led to a convergence of communications products and services. Companies that may be classified as telecommunications, cable, wireless, satellite or Internet service providers have the capability to provide voice, data, video and Internet access services individually or as part of a bundle of services. Many companies are already offering these packages of multiple services. However, as a result of historic differences in the regulatory classification of businesses that sell voice, data, video and Internet access services, such companies are taxed differently merely because of such classifications.

The current definition of "Internet Access" in Section 1104 reads as follows:

> (5) INTERNET ACCESS.—The term "Internet access" means a service that enables users to access content, information, electronic mail, or other services offered over the Internet and may also include access to proprietary content, information, and other services as part of a package of services offered to users. *Such term does not include telecommunications services. (emphasis added)*

As telecommunications service providers, we are concerned that the exclusion of telecommunications service from the definition of Internet Access may result in Internet Access services provided by telecommunications companies being taxable while Internet Access services by cable companies, direct satellite companies, and Internet service providers are exempt from taxation. This disparity places our companies at a competitive disadvantage when we sell Internet Access.

Here are some real-world examples. Currently, high speed Internet Access provided by cable modem service or by direct satellite is exempt from state and local taxes except in those states grandfathered under the Act. Cable modem service competes directly with DSL service provided by telecommunications companies, and wireless carriers are now rolling out wireless Internet Access service that will offer consumers another alternative to both DSL and cable modem service.

Some states have taken the position that DSL service is not Internet Access, but a "bundle" that includes both Internet Access and telecommunications service. As a result, they claim that part of the charge is taxable. Subjecting part or all of our charges for Internet Access to state and local taxation is a significant tax burden on our customers and is contrary to the intent of the Internet Tax Non-Discrimination Act. As we have previously testified to your Committee, the effective tax rate on telecommunications companies and their customers averages over 17% as compared to just over 6% for other businesses, according to a recent study by the Council on State Taxation.

It is ironic that legislation designed to prevent multiple and discriminatory taxation of Internet Access and electronic commerce specifically excludes the one service that is absolutely vital to the functioning of the Internet—the telecommunications backbone—and the one service that is subject to one of the highest discriminatory state and local tax burdens in the country.

When considering reauthorization of the Internet Tax Non-Discrimination Act, we urge the Committee and the Congress to clarify the definition of Internet Access to both remove uncertainty and create tax parity for all providers of Internet Access

and electronic commerce products and services. We look forward to working with the Committee on legislation that will accomplish these important changes.

April 9, 2003

The Honorable Chris Cannon, Chairman
Subcommittee on Commercial and Administrative Law
B-353 Rayburn Office Building
Washington, DC 20515

Dear Chairman Cannon:

On behalf of the Multistate Tax Commission, enclosed are five (5) copies of our statement on HR 49, the Internet Tax Nondiscrimination Act , legislation that was heard before the Subcommittee on April 1, 2003.

A copy of this statement has been sent under separate cover to each Member of the Subcommittee.

We hope the Commission's insights into this legislation are helpful to the Members of the Subcommittee. If you have any questions, please do not hesitate to contact Ellen Marshall, the MTC's legislative consultant, at 202-662-3712.

Sincerely,

Elizabeth Harchenko

Elizabeth Harchenko, Chair
Multistate Tax Commission

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PREPARED STATEMENT OF ELIZABETH HARCHENKO

The Multistate Tax Commission is pleased to present this statement regarding the Subcommittee's consideration of HR 49, the *Internet Tax Nondiscrimination Act* of 2003.

The Multistate Tax Commission is an organization of state governments that works with taxpayers to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises. 44 states and the District of Columbia participate in the Commission. Formed by an interstate compact, the Commission:

- encourages tax practices that reduce administrative costs for taxpayers and States alike,
- develops and recommends uniform laws and regulations that promote proper state taxation of multistate and multinational enterprises,
- encourages business compliance with state tax laws through education, negotiation and enforcement, and
- protects state fiscal authority in Congress and the courts.

The Commission monitored provisions contained in the *Internet Tax Freedom Act* when it was enacted in 1998 for their potential impact on state taxing authority. The Commission maintains a neutral position on congressional action on the original Act and its successor, the *Internet Tax Nondiscrimination Act*. The Commission does make several recommendations with regard to specific provisions of the Act should Congress choose to extend the Act. This position is reflected most recently in the approval of Commission Resolution 01-08 approved in July 2001 (attached).

The Commission believes that five guidelines should be addressed as Congress considers extending the *Internet Tax Nondiscrimination Act* upon its expiration in October 2003. Principally, these guidelines include:

- The Act should be extended for no more than two years to insure a review of its impact on state and local revenues and the presence of unintended consequences. The changing nature of Internet technology and its use in business operations means that the economic and fiscal impact of this Act will change. A temporary extension is appropriate in this context.
- Any extension of the Act should preserve the grandfathered ability of those states currently imposing a tax on charges for Internet access to continue to do so if they so choose.
- The definition of Internet access contained in the Act should be rewritten to eliminate opportunities to bundle otherwise taxable content into a single package of Internet access in a manner that would prevent states and localities from imposing their taxes on the otherwise taxable content, thus preserving competitive equity among all forms of commerce.
- Any extension of the Act should not be accompanied by provisions or separate legislation that grants more favorable state and local tax treatment to commerce involving goods or services transferred, conducted or delivered by electronic or other remote means as compared to commerce involving goods or services transferred, conducted, or delivered by other means.
- The definition of discriminatory taxes contained in the legislation should be amended to insure that it does not allow a seller through affiliates to avoid a tax collection obligation in a state even though the seller has a substantial nexus in the state.

Extending the Act and the Potential Economic Impact. A moratorium on taxation of Internet access charges was originally imposed in 1998 as a means of providing the then-burgeoning Internet industry with protection from the sudden imposition of certain specific state and local taxes. Five years ago, it was clear that the Internet industry would become a major force in the economy and that some temporary measures might be warranted to insure that the Internet industry did not suffer from a burden of over-regulation or taxation. Today, the Internet is a vibrant, well-established industry that is a major component of the national economy. Thus, the moratorium was enacted as a temporary measure-but its continued effectiveness and necessity should be re-examined periodically.

The Commission believes that several questions regarding the potential economic impact on the Internet industry and state and local governments should be posed when considering whether to extend the existing moratorium:

- Does the current preemption of taxation of Internet access create discrimination in favor of a select group of Internet providers? Specifically, are large companies that have the ability to bundle Internet access with other services

(like telecommunications, information, or entertainment) provided an advantage over smaller companies without the financial means to provide bundled services?

- To what extent have studies documented that a pre-emption of taxation of Internet access has increased the volume of subscribers to such access?
- Conversely, to what extent have studies documented that taxing Internet access has served as a deterrent to potential subscribers? Specifically, the existence of state taxes on Internet access in nine of the states covered by the grandfather provision of the legislation provides for a basis for comparing the growth of Internet access in those states vs. other states. Will Congress make this comparison before making a decision on extending the Act?
- In lieu of taxing Internet access, have states and localities imposed or increased other taxes on the Internet industry to compensate for the loss of revenue?

In addition to considering the above, HR 49 also proposes repealing the grandfather clause in the existing moratorium that provides nine states with the ability to continue imposing taxes on Internet access that were in effect when the original law was enacted. The Commission believes that repealing this grandfather would represent an inappropriate pre-emption of a state's existing taxing authority. The states protected by the grandfather clause-New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Tennessee, Texas, Washington, and Wisconsin-tax Internet access under their current laws that govern the taxation of services. The revenue generated from the imposition of the tax is an important component in the revenue base of each of these states-many of which are now struggling to balance their individual state budgets. To repeal the grandfather clause for these states would represent an erosion of their revenue base, shift increasing responsibility for the tax burden to other taxpayers, and upset the balance of the states' internal tax policy objectives.

Definition of Internet Access. Any consideration of extending the moratorium must include a re-evaluation of the definition of Internet access within the moratorium to account for the increasing variety and extent of services that are "bundled" with access.

Since Congress wrote the original definition, changes in technology and corporate business structures have made it clear that it is now possible for large enterprises to bundle a broad array of otherwise taxable services with Internet access. The current definition appears to create the potential for discrimination in tax policy that would stifle competition and increase consumer costs, provide financial advantages to large enterprises, and erode state and local tax bases. Services delivered by large enterprises that can assemble the capital, technological, information and entertainment resources to bundle an array of services with Internet access would appear to be granted a tax exemption under the current language of the moratorium. The same services delivered through the Internet by smaller enterprises without the bundling capability or by non-electronic means would remain taxable. There is no economic or tax policy justification for Congress to create this disparity. Expanded bundling by large enterprises can substantially erode the tax bases of state and local governments that tax services.

The definition of Internet access should cover only access to the Internet. Because of the increasing problems in distinguishing between pure access and other services, Congress should explore a quantitative approach to defining access, such as was enacted by the State of Texas in the last few years. A quantitative approach to defining Internet access removes all ambiguity concerning what constitutes "access" as opposed to other services. Further, it creates a level playing field among all providers of Internet access.

Discriminatory Taxes. Sections 1104(2) (A) (iii) and 2(B) (ii) (II) of the1998 Internet Tax Freedom Act and its successor, the Internet Tax Nondiscrimination Act, are components of the definition a discriminatory tax. In its entirety, the definition was intended to protect on-line retailers from unfair taxation by states and localities so that e-commerce would receive same tax treatment as all other forms of remote commerce. Read together, the interplay between these two provisions could have another, unintended effect by encouraging brick and mortar retailers to engage in sophisticated tax planning strategies that will allow them to escape the responsibility to collect sales tax on sales made in those states where they otherwise have clear sales tax nexus. Across the nation, large brick and mortar retailers with nexus in various states have attempted to escape sales tax collection on in-state sales by creating a separate, out-of-state Internet-based sales subsidiary to handle customer orders and payments, despite the substantive operational ties that exist between the parent retailer and its Internet subsidiary. Such ties may include allowing cus-

tomers to return items purchased from the Internet subsidiary to the parent retail store, or having the parent retail company distribute promotional items on behalf of its subsidiary. Though there are other reasons why retailers might implement this "entity isolation" tax strategy to escape sales tax responsibility, the discriminatory tax definition in the Internet Tax Freedom Act has the appearance of sanctioning this kind of tax avoidance behavior. The result in these cases is unfair to other retailers who register and collect sales and use taxes.

SUMMARY

The Internet has developed from infancy to maturity with amazing speed and has become an invaluable segment of the nation's economy. What was once thought to be technology that would be used by a select few has become an integral part of everyday life for nearly all Americans. Recognizing that the Internet has reached this mature stage, Congress must now decide whether it is necessary to extend protections from regulation and taxation that it initially imposed. The Multistate Tax Commission strongly urges Congress to give careful consideration to the economic impact on states from this continued protection-as well as consideration of the consequences of federal pre-emption of state taxing authority. In addition, Congress should seriously examine if extending the current moratorium on taxation of Internet access creates potential disparities and competitive disadvantages in the marketplace among providers of Internet access. A careful review and analysis of these issues should provide Congress with the background it needs to determine if extension of the *Internet Tax Nondiscrimination Act* is warranted at this time.

ATTACHMENT

Multistate Tax Commission

Resolution No. 01-08

Resolution Regarding Tax Fairness in the Proposed Federal Extension of the "Internet Tax Freedom Act"

WHEREAS, the Internet Tax Freedom Act expires on November 21, 2003; and

WHEREAS, the Act imposes a moratorium on the imposition of new taxes on charges for Internet access and prohibits multiple and discriminatory taxes on electronic commerce; and

WHEREAS, Congress may consider various measures to modify and extend the Act, including an extension of the moratorium on the imposition of taxes on charges for Internet access and the elimination of the existing grandfather clause that permits states that already imposed and enforced such taxes to continue to do so; and

WHEREAS, electronic commerce business models, technology and practices have changed significantly since the enactment of the Act in 1998, especially in the areas of "access" and "content"; and

WHEREAS, certain of those changes, when coupled with an extension of the Act, could have unintended consequences and expose state and local revenue systems to substantial adverse consequences; and

WHEREAS, sound tax policy demands that all forms of commerce be treated equally, and

WHEREAS, there is no economic reason to justify treating electronic commerce, or other forms of remote commerce more favorably than any other form of commerce; and

WHEREAS, extension of the Internet Tax Freedom Act would constitute a preemption of state authority that is traditionally considered unacceptable by many state officials; and

WHEREAS, the Multistate Tax Commission recognizes that, nonetheless, Congress may choose to extend the Act; now therefore, be it

RESOLVED, that if Congress chooses to extend the Act, the Multistate Tax Commission respectfully urges it to do so in accord with the following guidelines:

- The Act should be extended for not more than two years to insure a review of its impact on state and local revenues and the presence of unintended consequences.

- Any extension of the Act should preserve the grandfathered ability of those states currently imposing a tax on charges for Internet access to continue to do so if they so choose.

- The definition of Internet access contained in the Act should be rewritten to eliminate opportunities to bundle otherwise taxable content into a single package of Internet access in a manner that would prevent states and localities from imposing their taxes on the otherwise taxable content, thus preserving competitive equity among all forms of commerce.

- Any extension of the Act should not be accompanied by provisions or separate legislation that grants more favorable state and local tax treatment to commerce involving goods or services transferred, conducted or delivered by electronic or other remote means as compared to commerce involving goods or services transferred, conducted or delivered by other means.

- The definition of discriminatory taxes contained in the bill should be amended to insure that it does not allow a seller through affiliates to avoid a tax collection obligation in a state even though the seller has a substantial nexus in the state.

Adopted this 27th day of July, 2001 and amended August 2002 by the Multistate Tax Commission

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Dan R. Bucks, Executive Director

This resolution, as amended, shall expire at the Annual Business Meeting of the Multistate Tax Commission in 2006.

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